IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

DIANE ROMERO,	)	
	)	
Plaintiff,	)	
	)	
v.	)	Civil Action No. 793-N
	)	
CAREER EDUCATION CORPORATION,	)	
	)	
Defendant.	)	

MEMORANDUM OPINION

Submitted: April 1, 2005
Decided: July 19, 2005

Joseph A. Rosenthal, Esquire, Jessica Zeldin, Esquire, ROSENTHAL, MONHAIT, GROSS & GODDESS, P.A., Wilmington, Delaware; Eric L. Zagar, Esquire, SCHIFFRIN & BARROWAY, LLP, Radnor, Pennsylvania, *Attorneys for Plaintiff*

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PARSONS, Vice Chancellor.

Diane Romero brought this action, pursuant to 8 *Del. C.* § 220, seeking to compel inspection of certain books and records of Career Education Corporation ("CEC"). CEC moved to dismiss Romero's Complaint under Court of Chancery Rule 12(b)(6), or alternatively, to stay. For the reasons discussed below, the Court will deny CEC's motion.

I. FACTS

CEC is a Delaware corporation that provides private, postsecondary education at 81 schools located primarily in North America and Europe. CEC's conventional campuses and online schools offer programs which grant associate, bachelor's, master's and doctoral degrees in various disciplines. Because CEC and their students receive state and federal financial aid, its schools are subject to oversight by state postsecondary authorizing agencies, accrediting agencies recognized by the United States Department of Education ("DOE") and the DOE itself.

Romero has been a beneficial owner of 100 shares of CEC stock since November 25, 2003. On January 6, 2004, she served a written demand on CEC to inspect and make copies of certain books and records of CEC (the "January 6 Demand"). Romero's Demand sought documents relating to (i) CEC's alleged falsification of records regarding student enrollment, retention, and graduation; (ii) CEC's ethics and whistleblower policies and procedures; and (iii) the acquisition, sale, purchase, transfer or brokering of CEC common stock by CEC officers and directors.

On May 26, 2004, in response to a request from CEC, Romero provided CEC with a more narrowly-tailored demand (the "May 26 Demand").[1] Romero therein stated that the purpose of her demand was to investigate possible breaches of fiduciary duties by CEC's board of directors and executive officers. The possible breaches of fiduciary duty are claimed to stem from

> actively participating in, or failing to make a good faith effort to detect, investigate, prevent and correct, violations of the Ethics Codes, particularly with regard to falsification of, or other wrongdoing or impropriety with respect to, records of student enrollment, retention, and graduation.[2]

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[1] The requests of the May 26 Demand are as follows:

1. All memoranda, presentations, reports, minutes, and resolutions created by, distributed to, or reviewed by CEC's Board of Directors (the "Board"), any member or committee of the Board, and/or any of the Executive Officers (as defined in the Demand) regarding any alleged falsification of, or other wrongdoing or impropriety with respect to, records of student enrollment, retention, and/or graduation.

2. All memoranda, presentations, reports, minutes, and resolutions regarding any internal or external investigation of any alleged falsification of, or other wrongdoing or impropriety with respect to, records of student enrollment, retention, and/or graduation.

3. All memoranda, presentations, reports, minutes, resolutions, and manuals regarding the Company's policies and/or procedures for:

    a. detecting violations of CEC's Code of Business Conduct and Ethics and/or the Code of Ethics for Executive Officers and Senior Financial Officers of CEC (collectively, the "Ethics Codes");

    b. investigating alleged violations of the Ethics Codes;

    c. responding to violations of the Ethics Codes; and/or

    d. preventing violations of the Ethics Codes.

[2] May 26 Demand at 2.

The parties then entered into a confidentiality agreement whereby CEC agreed to produce the books and records described in the May 26 Demand. CEC, however, only produced 152 pages of documents, many of which were publicly filed 10-Ks. Romero questions the completeness of CEC's production, and on November 3, 2004, filed this action.

A. Pending Proceedings

Following reports by local papers in Bergen County, New Jersey and Santa Barbara, California in November and December of 2003, a number of federal securities class action suits were filed against CEC and later consolidated as *Taubenfeld v. Career Education Corp.*[3] The putative class consists of shareholders who purchased CEC stock between January 28, 2003 and December 2, 2003 and therefore includes Romero. The *Taubenfeld* Amended Complaint alleges that CEC and two of its senior officers violated federal securities laws by, among other things, failing to disclose that CEC had falsified student records regarding its student starts, enrollment and graduation rates and by improperly reporting its financial results and condition.[4] Discovery in *Taubenfeld* is currently stayed pursuant to the Private Securities Litigation Reform Act of 1995 (the "PSLRA")[5] pending the outcome of defendants' motion to dismiss the Amended Complaint.

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[3] No. 03 C 8884 (N.D. Ill. filed Dec. 9, 2003).

[4] Dent Aff. Ex. A.

[5] Pub. L. No. 104-67, 109 Stat. 737 (1995).

In addition, a number of derivative actions also have been filed. Those actions include allegations that essentially mirror those of the *Taubenfeld* Amended Complaint, but assert derivative claims for breach of fiduciary duty instead of federal securities fraud. The derivative cases include (i) *McSparran v. Larson, et al.*,[6] (ii) *Huang v. Larson, et al.*,[7] and (iii) *Nicholas v. Dowell, et al.*[8]

B. The CEC Board's Special Committee Investigation

On June 30, 2004, CEC's Board of Directors formed a Special Committee to conduct an independent investigation of the allegations made in the various class and derivative actions filed against and on behalf of CEC and certain of its officers and directors. As of last report, the Special Committee is in the process of investigating those allegations.

II. ANALYSIS

A motion to dismiss under Rule 12(b)(6) will be granted where it appears with reasonable certainty that the plaintiff cannot prevail on any set of facts that can be inferred from the pleadings.[9] Plaintiff is entitled to all reasonable inferences that can be

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6 No. 04 C 0041 (N.D. Ill. filed Jan. 5, 2004). Another similar suit, *Ulrich v. Larson, et al.*, No. 04 C 4778 (N.D. Ill.) has been consolidated with *McSparran*.

7 No. 04 CH 10579 (Ill. Cir. Ct., Ch. Div. filed July 2, 2004).

8 C.A. No. 819-N (Del. Ch. filed Nov. 10, 2004), *stayed pending McSparran*. On June 3, 2005, Romero herself filed a derivative action, which is currently the subject of a motion to dismiss. *Romero v. Dowdell, et al.*, C.A. No. 1398-N (Del. Ch.).

9 *E.g.*, *Leonard Loventhal Account v. Hilton Hotels Corp*., 2000 WL 1528909, at *3 (Del. Ch. Oct. 10, 2000).

drawn from the Complaint. CEC advances two primary grounds for its motion to dismiss and they are discussed below.

A. Romero's Proper Purpose

Section 220 requires that a stockholder seeking inspection of books and records state a proper purpose for the inspection. Section 220(b) defines a "proper purpose" as one "reasonably related to such person's interest as a stockholder."

CEC argues that Romero's Complaint fails to satisfy the pleading burden under 8 *Del. C.* § 220. According to CEC, a § 220 plaintiff's complaint must offer evidence of possible mismanagement and demonstrate that each category of books and records sought is "essential" to her purpose. CEC contends that Romero's May 26 Demand and Complaint fail to state a proper purpose and that her stated purposes are rendered superfluous by the other pending actions and the ongoing Special Committee investigation.

CEC relies on *Security First* for the proposition that the threshold pleading burden for a plaintiff in a § 220 action "is not insubstantial."[10] *Security First*, however, does not refer to a plaintiff's pleading burden under § 220, but rather, its burden of proof at trial.[11] In fact, quite to the contrary, this Court has held that the basis for a § 220 plaintiff's

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[10] *Security First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 568 (Del. 1997).

[11] *Id.* at 567 ("At the trial of a summary proceeding under 220(d), the Plaintiff must show the credible basis by a preponderance of the evidence.").

suspicions "can best be addressed after the factual record is developed at trial."[12] The same rationale applies in the context of an evaluation of the adequacy of a § 220 plaintiff's inspection demand.

In Romero's case, I find that her demands and Complaint sufficiently allege a proper purpose. Romero seeks to investigate possible breaches of fiduciary duties and mismanagement by CEC's directors and officers. The Complaint seeks books and records that relate to the falsification of enrollment, attendance and graduation records and a failure to detect, investigate, respond to, and prevent the suspected misconduct. CEC's own former employees have filed lawsuits alleging that the Company conferred degrees on students who did not complete required courses and falsified records in order to inflate its schools' financial and operational performance. Importantly, CEC's own Board has appointed a Special Committee to conduct an internal investigation into the same matters. Taken together, these averments provide ample basis for Romero to withstand a motion to dismiss for failure to allege a proper purpose.

When the facts are developed at trial in the context of all the relevant circumstances, the existence of pending suits arising out of the same nucleus of operative facts may lead to a rejection of Romero's claims of a proper purpose. Section 220 has been described by then-Vice Chancellor Steele, however, as a statutory right of "independent legal significance."[13] At this preliminary stage, the possibility remains that

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12 *Deephaven Risk Arb Trading Ltd. v. UnitedGlobalCom, Inc.*, 2004 WL 1945546, at *8 (Del. Ch. Aug. 30, 2004).

13 *Cutlip v. CBA Int'l, Inc.*, 1995 WL 694422, at *2 (Del. Ch. Oct. 27, 1995).

Romero will be able to demonstrate a proper purpose that would not be obviated by the pending suits. I therefore find that CEC has not established that the Romero cannot show a proper purpose based on any set of facts that can be inferred from the pleadings.

B. Effect of the PSLRA and SLUSA

CEC argues that Romero's Complaint should be dismissed or stayed because her Demand interferes with the automatic stay of the *Taubenfeld* action pursuant to the PSLRA, and is preempted by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[14]

The PSLRA was enacted in 1995 and expressly prohibits discovery or other discovery-related proceedings in securities class actions while there is a pending motion to dismiss.[15] The PSLRA, however, does not apply to individual or derivative suits[16] and excepts certain class action claims involving corporate transactions that are brought in the state of incorporation.[17] Three years later, Congress passed SLUSA to strengthen the PSLRA. Among other things, SLUSA allows a court to "stay discovery proceedings in

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14 Pub. L. No. 105-353, 112 Stat. 3227 (1998).

15 15 U.S.C. § 78z-1(b)(1) ("In any private action arising under this subchapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds, upon the motion of any party, that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.").

16 15 U.S.C. § 77p(f)(2)(B); *see also City of Austin Police Ret. Sys. v. ITT Educ. Serv., Inc.*, 2005 WL 280345, slip op. at *10 & n.2 (S.D. Ind. Feb. 2, 2005) ("[T]he PSLRA and SLUSA were not intended to protect corporate management from shareholder derivative claims. Those are left to state law.").

17 15 U.S.C. § 77p(d)(1).

any private action in a State court as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to [the PSLRA]."[18]

CEC's preemption argument is unpersuasive. Both Delaware and federal courts have determined that the PSLRA and SLUSA do not necessarily preempt § 220 actions. In *Cohen v. El Paso Corp.*, Chancellor Chandler addressed a factual circumstance very similar to the case at bar, rejecting defendant El Paso's argument that plaintiff's § 220 action was in direct conflict with a stay in a federal action:

> El Paso argues that the effect of the PSLRA and SLUSA is to preempt this Court from hearing Cohen's § 220 action on its merits. This argument is a non-starter.
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> * * * *
>
> Neither the PSLRA nor SLUSA prevents a state court from considering a books and records demand, or similar state corporate law claims, merely because one of the parties to the state action is protected by a PSLRA automatic discovery stay in an unrelated federal securities class action.[19]

Likewise, in denying a motion by defendants in a federal class action to stay a § 220 action pursuant to SLUSA, the federal court in *City of Austin* held:

> [T]he court finds that the defendants in this case have not made "a proper showing" at this point requiring a stay of Stein's Section 220 action in the Delaware courts. The Section 220 action is not a securities fraud case, nor a

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[18] 15 U.S.C. § 77z-1(b)(4), § 78u-4(b)(3)(D).

[19] 2004 WL 2340046, at *3 (Del. Ch. Oct. 18, 2004). After the Chancellor declined to stay the action under SLUSA, the district judge presiding over the federal action entered a summary order staying *Cohen* without specifying its reasons. *Wyatt v. El Paso Corp.*, No. H-02-2717 (S.D. Tex. Dec. 8, 2004).

> precursor to one. It is instead a precursor to a possible shareholder derivative action under the law and in the courts of the state of incorporation. There is no indication that the Section 220 action is intended to circumvent this court's stay of discovery under the PSLRA. The court also sees no threat to this court's jurisdiction, its judgments, or its ability to manage and decide this federal securities fraud case.[20]

Notwithstanding *Cohen* and *City of Austin*, CEC resolutely argues that "because there is a 'conflict' here between the PSLRA and Section 220, Plaintiff's Section 220 action should be dismissed."[21] CEC focuses on language from *Cohen* stating that "[c]onflict between the PSLRA with § 220 will potentially arise only when the § 220 action is seeking records that pertain directly to a federal securities law claim asserted in a pending federal action . . . ."[22] What CEC ignores, however, is that the court in *Cohen* only identified circumstances where a conflict "will *potentially* arise."[23] Because SLUSA was intended to prevent plaintiffs from using state court actions to evade discovery stays pursuant to the PSLRA, the quoted language merely identifies the types of actions where that risk is likely to exist. Whether a particular § 220 action should be dismissed will depend on the circumstances of that case.

Under CEC's logic, whenever a § 220 plaintiff seeks documents that could be relevant to a securities class action stayed pursuant to the PSLRA, the court should apply

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20 2005 WL 280345, at *11.

21 CEC's Reply Br. at 7.

22 *Cohen*, 2004 WL 2340046, at *3.

23 *Id.* (emphasis added).

a *per se* test and automatically stay the § 220 action. The court in *City of Austin* rejected a similar argument, holding:

> Defendants contend the standard should be objective, so that intent to evade a stay under the PSLRA or intent to share the results of discovery with the federal plaintiffs would be irrelevant. . . . As discussed in the hearing, defendants' proposed standard would apply far too broadly, reaching state court cases in which the claims would be entirely different, and in which the federal defendants would not even need to be parties.[24]

Instead, the court adopted a subjective test, explaining that "intent to evade the PSLRA stay of discovery would weigh heavily in favor of a stay under SLUSA."[25]

At the motion to dismiss stage where all inferences must be drawn in plaintiff's favor, I am not convinced that Romero's purpose is to circumvent the PSLRA's proscriptions. The purposes identified in support of Romero's May 26 Demand, for example, include investigating whether the CEC Board or officers breached their fiduciary duties by "actively participating in, or failing to make a good faith effort to detect, investigate, prevent and correct, violations of the Ethics Codes." It is certainly conceivable that any resulting claim for violation of fiduciary duties under Delaware law would be entirely different from the pending federal claims against CEC or its agents. It is also noteworthy that the parties have entered into a confidentiality agreement that prohibits sharing materials obtained in this case for purposes other than those outlined in the May 26 Demand, and that the scope of inspection under 8 *Del. C.* § 220 is much

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[24] 2005 WL 280345, at *9.

[25] *Id.* at *10.

narrower than discovery in general litigation. Moreover, Romero has not been involved in the *Taubenfeld* action, and her counsel, Schiffrin & Barroway, has represented to this Court that, although they were involved in *Taubenfeld*, they have no continuing involvement.[26] Thus, consistent with *Cohen* and *City of Austin*, I conclude that CEC has not shown that this action conflicts with either the PSLRA or SLUSA, such that it would be preempted by either of those statutes.

III. CONCLUSION

For the foregoing reasons, CEC's motion to dismiss or stay is denied.

IT IS SO ORDERED.

[26] Zagar Aff. ¶ 2. On April 1, 2005, a Second Amended Complaint was filed in *Taubenfeld* that included Schiffrin & Barroway as counsel for one of the plaintiffs, Gordon MacKinney. Schiffrin & Barroway, however, aver that their inclusion in the caption for the Second Amended Complaint was an error and that they are no longer involved in that case.