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Contracts, Control and Charter Schools: The Success of Charter Schools Depends on Stronger Nonprofit Board Oversight to Preserve Independence and Prevent Domination by For-Profit Management Companies

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CONTRACTS, CONTROL AND CHARTER SCHOOLS:
THE SUCCESS OF CHARTER SCHOOLS DEPENDS ON
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COMPANIES

*Julia L. Davis**

I. INTRODUCTION

A. “Education Entrepreneurs” and Charter School Control

A recent *New York Times* article profiled energy executive Dennis Bakke and his wife Eileen, who, after retiring from his business, decided to enter the world of commercial charter schools “to experiment with applying business strategies and discipline to public schools.”¹ The couple’s company, Imagine Schools, is now the largest for-profit manager of charter schools in the country.² The piece was less than glowing and revealed a number of government officials and disgruntled charter school board members who reported the company’s attempts to dominate and control their communities’ non-profit charter schools.³

Imagine is not the only commercial charter school manager, known in the education world as an education management organization (“EMO”).⁴ Companies like Mosaica Education

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1. Stephanie Strom, *For Charter School Company, Issues of Spending and Control*, N.Y. TIMES, April 24, 2010, at A1.

2. *Id.*

3. *Id.*

4. NAT’L CHARTER SCH. RESEARCH PROJECT, CTR. ON REINVENTING PUB. EDUC., DANIEL J. EVANS SCH. OF PUB. AFFAIRS, UNIV. OF WASH., QUANTITY COUNTS: THE

Inc., Edison Schools, Inc., Charter Schools USA, White Hat Management and Chancellor Beacon Academies (which merged with Imagine in 2004) now manage between nine and twelve percent of all charter schools in the U.S.⁵ Imagine's recent bad press is emblematic of the problems with for-profit companies managing charter schools that are emerging across the country.⁶ As the *Times* notes, "[R]egulators . . . have found that Imagine has elbowed the charter holders out of virtually all school decision making – hiring and firing staff members, controlling and profiting from school real estate, and retaining fees under contracts, which often guarantee Imagine's management in perpetuity."⁷ Imagine's methods, which are not unlike those of other management companies discussed in detail in this paper, unapologetically flout traditional nonprofit law by co-opting independent non-profit charter school boards who are their clients and creating obvious conflicts of interest in the financial operations of the schools they manage. According to the former president of the National Charter Schools Alliance (which is now defunct), "Imagine works to dominate the board of the charter holder, and then it does a deal with the board it dominates – and that cannot be an arm's length transaction."⁸ The District of Columbia Charter School Board, which grants and oversees charters in Washington, said that it had "concerns about who was running the show" at an Imagine-managed school in the city, and remarked more broadly, "it is very hard for schools that hire management companies to maintain their independence, and charter schools are supposed to be independent."⁹ According to the same

GROWTH OF CHARTER SCHOOL MANAGEMENT ORGANIZATIONS (Aug. 2007), available at http://www.crpe.org/cs/crpe/download/csr_files/pub_nesrp_quanccount_aug07.pdf [hereinafter NAT'L CHARTER SCH. RESEARCH PROJECT]. The author uses the terms "EMO" and "for-profit management company" interchangeably in this paper.

5. *Quantity Counts: The Growth of Charter School Management Organizations*, U.S. CHARTER SCHOOLS, http://www.uscharterschools.org/csr/view/uscs_rs/2341 (last visited Oct. 20, 2010) ("For-profit education management organizations (EMOs) and nonprofit charter management organizations (CMOs) represent a small but growing portion (approximately [nine] percent) of charter schools nationally."); Frank R. Kemerer & Catherine Maloney, *The Legal Framework for Educational Privatization and Accountability*, 150 EDUC. L. REP. 589, 605 (2001) (twelve percent of charter schools are operated by private organizations).

6. Greg Richmond, *Who's in Charge at Charter Schools? Six Criteria for Ensuring the Quality of Governing Boards*, EDUC. WK., July 12, 2010.

7. Strom, *supra* note 2.

8. *Id.*

9. *Id.*

education official, the “entire model of using management companies is flawed.”¹⁰ Indeed, the New York State legislature recently prohibited charter schools from hiring for-profit companies to manage schools.¹¹

In Texas, parents who were attempting to create a charter school with Imagine found that the company “thought the charter belonged to them.”¹² In a damning email sent by Imagine’s founder to senior staff, Mr. Bakke reminded his executives that the management company is “responsible for making big decisions about budget matters, school policies, hiring of the principal and dozens of other matters.”¹³ “It is our school, our money and our risk, not theirs.”¹⁴ Press reports like these have damaged the credibility of the charter school movement, and raised questions about the appropriate role of EMOs and the proper oversight of government officials and legislators. Some commentators have called for a prohibition on for-profit EMOs managing charter schools altogether because of “inherent” conflicts between the goals of public education and for-profit business.¹⁵

A new funding initiative called Race to the Top, created by the Obama administration, raises the stakes for charter schools by tying vast amounts of federal education grants to states’ lifting caps on the number of charter schools they permit.¹⁶ In the face of financial crisis, many states are scrambling to close state education budget shortfalls. Some are closing schools, laying off teachers, and searching for other sources of revenue.¹⁷ In this context, states have significant incentives to relax the barriers to charter schools in order to obtain millions in federal aid. In New York, for example, the legislature significantly increased the cap on charter schools from 200 to

10. *Id.*

11. New York State Senate Bill A11310.

12. Strom, *supra* note 2 (quoting Karelei Munn).

13. Associated Press, *Charter School Operator Accused*, THE JOURNAL GAZETTE, Oct. 25, 2009, available at <http://www.journalgazette.net/article/20091102/LOCAL10/911029966/1216/LOCAL1006>.

14. *Id.*

15. Kathleen Conn, *For-Profit School Management Corporations: Serving the Wrong Master*, 31 J.L. & EDUC. 129, 147 (2002).

16. U.S. DEPARTMENT OF EDUCATION, RACE TO THE TOP EXECUTIVE SUMMARY 11 (2009), available at <http://www2.ed.gov/programs/racetothetop/executive-summary.pdf>

17. See, e.g., Rhonda Holman, Editorial, *State’s Shortfall Stretching Schools*, THE WICHITA EAGLE, Dec. 13, 2009, available at <http://www.kansas.com/2009/12/13/1096210/states-shortfall-stretching-schools.html>.

460 state-wide following its failure to win \$700 million in Race to the Top funds during the first round of the competitive application process in order to make the state eligible to reapply.¹⁸

This is a critical time for charter schools as they are increasingly held by politicians and the public as a solution for failing public schools.¹⁹ In addition to federal support, charter schools have attracted the interest of private philanthropists and foundations.²⁰ Even the once hostile teachers' unions are finding a role to play in charter school education.²¹ What was an experiment of the early 1990s is now increasingly part of the fabric of public education throughout the United States. Scrutiny has followed.

While most research has focused on determining whether charter schools produce better academic achievement for students, anecdotal information from the press, the courts, and the Internal Revenue Service reveals an emerging problematic by-product of the movement's reliance on private organizations and competition—namely improper domination of nonprofit charter school boards by for-profit management companies.²² Scholarly critique has focused on some of the constraints placed on EMOs to ensure they put pupils before profits, but little has been written about the risks that face nonprofit schools that contract with EMOs or the appropriate role charter school boards should play to ensure schools serve students and the community with public dollars.

For charter schools to meet the requirements of accountability and financial stewardship that their use of public funds requires, the relationships between nonprofit charter school boards and management companies must radically change. State and federal reforms are necessary to promote school independence, bolster credibility in the charter school movement generally, and prevent charter school

18. Jennifer Medina, *State Senate Approves Bill to Increase Charter Schools*, N.Y. TIMES, May 4, 2010, at A28.

19. Amanda Ripley, *Waiting for "Superman": A Call to Action for Our Schools*, TIME MAGAZINE, September 23, 2010, at 1.

20. Nancy Hass, *Scholarly Investments*, N.Y. TIMES, DEC. 6, 2009, at ST1.

21. Sam Dillon, *As More Charter Schools Unionize, Educators Debate the Effect*, N.Y. TIMES, July 27, 2009, at A1.

22. See, e.g., Richmond, *supra* note 7.

domination by EMOs in jurisdictions where they are permitted to operate.

This paper seeks to: (1) describe and analyze how the IRS, two states' legislatures, and courts have recently attempted to limit the control of management companies over nonprofit charter schools; (2) demonstrate the limitations and weaknesses of the current state of the law and, (3) recommend areas for rulemaking at the state and federal level to help nonprofit charter-holding organizations attain effective oversight of for-profit management companies and to protect them from the threat of tax exemption revocation and intermediate sanctions for excess benefit transactions.

B. A Brief History of the Charter School Movement

The charter school movement in the United States is nearly twenty years old²³ and its history reflects a generation of struggle among a broad range of stakeholders to improve the education available to the country's youth.²⁴ Today, there are over 4,000 charter schools (also known in some states as "community schools") serving more than 1.2 million school-aged children in 40 states.²⁵ Roughly three percent of school-aged children attend a charter school.²⁶

Charter schools are public schools that enjoy freedom from some of the state regulation that traditional public schools must follow;²⁷ however, as creatures of state legislation, charter schools must nonetheless follow state guidelines.²⁸ Generally, state law requires an organization seeking to start a school to make an application for a charter from a state or local education authority (e.g., a school board or a state regent) in

23. *History*, USCHARTERSCHOOLS.ORG, http://www.uscharterschools.org/pub/uscs_docs/o/history.htm (last visited Oct. 20, 2010).

24. See, e.g., James Forman, Jr., *Do Charter Schools Threaten Public Education? Emerging Evidence From Fifteen Years of a Quasi-Market for Schooling*, 2007 U. ILL. L. REV. 839 (2007).

25. *USCS State Profiles*, US CHARTER SCHOOLS, <http://www.uscharterschools.org/cs/sp/query/q/1595> (last visited Oct. 20, 2010). Since 1991, when Minnesota passed the first charter school legislation, 40 states, the District of Columbia and Puerto Rico have signed into law charter school legislation (AK, AR, AZ, CA, CO, CT, DC, DE, FL, GA, HI, ID, IL, IN, IA, KS, LA, MA, MD, MI, MN, MO, MS, NC, NH, NJ, NM, NV, NY, OH, OK, OR, PA, PR, RI, SC, TN, TX, UT, VA, WI, WY). States in which a charter school law has not been passed include: AL, KY, ME, MT, ND, NE, SD, VT, WA, and WV. *Id.*

26. NAT'L CHARTER SCH. RESEARCH PROJECT, *supra* note 5, at 3.

27. *History*, *supra* note 24.

28. *Id.*

order to receive public education funding.²⁹ The charter, if granted, is a kind of contract that outlines the obligations of the school and the expectations of the granting governmental body.³⁰ The charter may include a mutually-accepted mission for the school, details regarding the scope of the curriculum and any special area of focus, the students to be recruited (and whether the school may restrict access in any way through an application or residence requirement, or whether it is “open enrollment”), and indicators for determining whether the school is meeting its academic goals.³¹ Because charter schools are encouraged by state governments as a “laboratory” for education innovation, the charter is typically granted for a few years before it becomes ripe for renewal by the sponsor, permitting schools some time to develop before formal evaluation to determine whether they should continue.³² According to proponents, “charter schools . . . exercise increased autonomy in return for . . . [academic and fiscal] accountability” to “the sponsor that grants them [a charter], the parents who choose them, and the public that funds them.”³³

The ideas behind charter schools can be traced to education reform efforts beginning in the 1970s,³⁴ as well as broader trends to privatize government services more generally.³⁵ In 1991, Minnesota passed the first charter school law, followed a year later by California.³⁶ Charter schools have been a darling of both democrat and republican leadership, and among federal and state officials.³⁷ Charter schools appeal to ideological views on the right (school “choice,” market forces, competition, efficiency in government through out-sourcing) and the left (curriculum reform, community control and access to quality public education, especially for low-income and minority

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. For a discussion of the history behind early arguments for privatization of public education based on theories of government monopoly and the power of markets, see Lewis D. Solomon, *Edison Schools and the Privatization of K-12 Public Education: A Legal and Policy Analysis*, 30 FORDHAM URB. L.J. 1281, 1334 (2003).

36. *History*, *supra* note 24.

37. *Id.*

students).³⁸ This, however, does not mean that the movement has been without vocal detractors.³⁹ Nonetheless, the federal government has provided incentives for charter school creation under No Child Left Behind, which provides grants for failing public schools to reorganize as charter schools.⁴⁰ Other federal funds are also available to charter schools, including new initiatives of the Obama administration.⁴¹ Venture capital and private philanthropy is also a significant supporter of charter schools, bringing hundreds of millions of dollars into a landscape that has attracted management companies.⁴²

C. *Management Companies in Charter School Education*

Organizations and individuals seeking to create a charter school are usually grassroots nonprofits and parents, teachers and community leaders, entrepreneurs, or existing public or private schools converting to charter status.⁴³ The majority of charter schools in the U.S. are nonprofit organizations;⁴⁴ however, in a handful of states for-profit schools may receive a charter to contract directly with the state or local government to provide public education.⁴⁵ Even in states where for-profit

38. See, e.g., Bipartisan Support for Charter Schools, CTR. FOR EDU. REFORM, (May 6, 2008), http://www.edreform.com/published_pdf/Bipartisan_Support_for_Charter_Schools.pdf

39. Teachers' unions have been among the strongest opponents of charter schools. See generally AMERICAN FEDERATION OF TEACHERS, CHARTER SCHOOL LAWS: DO THEY MEASURE UP? (1996); see also William Haft, *Charter Schools and the Nineteenth Century Corporation: A Match Made in the Public Interest*, 30 ARIZ. ST. L.J. 1023 (1998), for a discussion of some of the movement's critics.

40. 20 U.S.C.A. §§ 7221, 7223, 6316(b)(8)(A)–(B)(i)(2010).

41. Press Release, U.S. Department of Education, President Obama, U.S. Secretary of Education Duncan Announce National Competition to Advance School Reform: Competition to Advance School Reform Obama Administration Starts \$4.35 Billion "Race to the Top" Competition, Pledges a Total of \$10 Billion for Reforms (July 24, 2009), <http://www.ed.gov/news/pressreleases/2009/07/07242009.html>.

42. PHILANTHROPY ROUNDTABLE, <http://www.philanthropyroundtable.org/content.asp?contentid=558> (last visited Oct. 20, 2010) (a recent meeting of leading philanthropists working on charter education included international, domestic and regional grant-makers); Scott Olster, *Forget Superman, Charter Schools are Waiting for Oprah*, FORTUNE, Sept. 30, 2010, available at http://money.cnn.com/2010/09/30/news/economy/waiting_for_superman.fortune/index.htm.

43. *History*, *supra* note 24.

44. See *Charter Schools: Finding out the facts: At a Glance*, CENTER FOR PUBLIC EDUCATION, <http://www.centerforpubliceducation.org/Main-Menu/Organizing-a-school/Charter-schools-Finding-out-the-facts-At-a-glance/default.aspx> (last visited Oct 22, 2010) (thirty percent of all charter schools are run by EMOs and sixteen percent of all charter schools are run by for-profit EMOs).

45. See, e.g., *id.*, at figure 1.

companies are prohibited from holding charters, for-profit companies may contract with nonprofit charter-holding organizations to manage facilities, oversee day-to-day operations, hire and fire teachers and execute the curriculum in charter schools.⁴⁶ Charter schools hire EMOs because the parties creating a new school often possess no or insufficient experience in managing schools.⁴⁷ Management companies offer this expertise and help newly formed schools save time and resources by adopting curricula that have been previously developed by the EMO, and by benefitting from pooled purchasing power for essential supplies, as the company negotiates preferred or discounted prices on behalf of the charter through economies of scale.⁴⁸

II. THE PROBLEM: INCOMPLETE LEGAL GUIDANCE TO ENSURE APPROPRIATE AND ACCOUNTABLE ROLES FOR NONPROFIT CHARTER SCHOOLS WHO CONTRACT WITH MANAGEMENT COMPANIES

From a legal perspective, charter schools occupy a shadowy terrain between purely “public” and “private” education, forcing state legislatures and the courts to develop rules to ensure the accountability that the public expects of public education, while permitting and encouraging the dynamism and experimentation available in autonomous private schools.⁴⁹ Over the last two decades, charter schools have become further complicated by not only crossing public and private boundaries, but merging nonprofit and for-profit organizational forms in the provision of education.⁵⁰

As previously mentioned, most states have made it impossible for for-profits to hold a charter directly, but loopholes remain to permit contracting with for-profits to manage the day-to-day operations of charter schools.⁵¹ Fears

46. John Morley, *For-Profit and Nonprofit Charter Schools: An Agency Costs Approach*, 115 YALE L.J. 1782, 1785–86 (2006); see also Conn, *supra* note 16, at 129–30.

47. David Walk, *How Educational Management Companies Serve Charter Schools and Their Students*, 32 J.L. & Educ. 241, 252 (2003).

48. *Id.*

49. Julie F. Mead, *Devilish Details: Exploring Features of Charter School Statutes that Blur the Public/Private Distinction*, 40 HARV. J. ON LEGIS. 349 (2003).

50. Morley, *supra* note 47, at 1788.

51. *Id.* at 1789–91.

that for-profit organizations would put profits before education likely motivated these state legislatures to avoid conferring charters on for-profit companies directly. The role of for-profit companies in charter school education has been a touchstone for many concerns of parents, teachers and other stakeholders that charter school laws will create a publically-funded for-profit education industry.⁵² In a 2007 report from The Center on Reinventing Public Education at the University of Washington, the authors described the “lessons learned” over more than a decade of charter school business based on interviews with the leaders of management companies.⁵³ Far from reassuring, the research makes no effort to capture the experience of nonprofit charter school boards (EMO clients) or local school officials, and reveals an industry that self-reports finding profits and growth challenging, due, in part, to the resistance of legislatures, boards and local community members to permit EMOs to use their packaged curricula and policies or “scale up” by operating multiple schools.⁵⁴ In language that this author suspects would raise the hackles of many charter-granting authorities, legislatures and education community members, EMOs are encouraged to be more disciplined about “client acquisition” to reduce the “costs” associated with shared decision-making, or tailoring pre-existing curricula or operations protocols.⁵⁵

The obvious strategy of for-profit management companies is to centralize decision-making, minimize nonprofit board member and community involvement, control the charter application process, resist requests to alter curricula and education “models,” and simultaneously capitalize on opportunities for expansion to increase scale and market share in the geographic region.⁵⁶ The result is a charter school that is incontrovertibly controlled by the management company, instead of the nonprofit board that received the government-issued charter for the school.

A recent ninth circuit court of appeals decision interpreting federal statute ruled that for-profit charter schools may not receive Elementary and Secondary Education Act or

52. *Id.*; see also Conn, *supra* note 16, at 131.

53. NAT’L CHARTER SCH. RESEARCH PROJECT, *supra* note 5, at 7.

54. *Id.* at 4–5.

55. *Id.* at 23–26.

56. *Id.*

Individuals with Disabilities Education Act funds.⁵⁷ As enormous revenue sources for charter schools, this ruling puts further pressure on nonprofit boards. EMOs who could operate their own for-profit schools in some states, following this ruling, must work for a non-profit charter school board if they wish to receive any of these federal funds. As for-profit companies realize that nonprofit charter schools are their “meal ticket” for funding from Washington, they will have more incentive to dominate and control the charter school boards they ostensibly serve.⁵⁸

Courts have been called upon to define and confine the relationships between nonprofit organizations and management companies, policing the interaction to ensure that nonprofits continue to provide oversight and leadership in the provision of education where for-profit companies are not permitted to hold charters.⁵⁹ It would appear, however, that potential conflicts of interest, weak oversight, and improper management company control in the charter school arena go un-litigated, arguably because of challenges facing plaintiffs to bring suits (lack of standing and limited causes of action⁶⁰) and lack of institutional resources for monitoring or enforcement (by state and local government, charter-conferring organizations, or attorneys general). A few state legislatures have amended their original charter school legislation to respond to the evolving role of for-profit companies working with charter schools, including defining the roles of boards and establishing safeguards for nonprofit independence.⁶¹

At the federal level, the relationships between for-profit management companies and nonprofit charter schools threaten a nonprofit’s tax exempt status. Language from the Internal

57. *Ariz. State Bd. for Charter Schs. v. U.S. Dep’t of Educ.*, 464 F.3d 1003 (9th Cir. 2006).

58. Mark D. Evans, *An End to Federal Funding of For-Profit Charter Schools?*, 79 U. COLO. L. REV. 617, 645–46 (2008).

59. See, e.g., *Carbondale Area Sch. Dist. v. Fell Charter Sch.*, 829 A.2d 400 (Pa. Commw. Ct. 2003); *W. Chester Area Sch. Dist. v. Collegium Charter Sch.*, 812 A.2d 1172 (Pa. Commw. Ct. 2002); *Brackbill v. Ron Brown Charter Sch.*, 777 A.2d 131 (Pa. Commw. Ct. 2001); *Sch. District of York v. Lincoln-Edison Charter Sch.*, 772 A.2d 1045 (Pa. Commw. Ct. 2001).

60. Conn. *supra* note 16, at 137 (discussing the legal barriers to bringing claims against management companies under existing corporate law and state-created “other constituency” statutes).

61. OHIO REV. CODE ANN. § 3314.03; see *Alternatives Unlimited-Special, Inc. v. Ohio Dept. of Educ.*, 861 N.E.2d 163 (Ohio Ct. App. 2006).

Revenue Service Manual for agency reviewers and a handful of IRS rulings provide insufficient guidance to nonprofits who seek to contract with for-profit management companies.⁶²

My analysis concludes that *ex post* gap-filling by the courts and *ad hoc* amendments by state legislatures are incomplete remedies to ensure that for-profit companies do not exploit superior resources and bargaining power to impermissibly control charter schools where they are not permitted to operate schools for profit. Clear *ex ante* rules are essential from the state legislature to help: (1) charter-granting organizations to detect when an application made by a nonprofit is merely an opportunity for an EMO's alter ego; (2) nonprofit boards to establish themselves with credibility, guide their board activity and oversight, and prevent conflicts of interest; and, (3) nonprofit boards structure the contracts they make with management companies to prevent excessive delegation. After nearly two decades of charter schools, it is clear that the courts' decisional law and state legislatures' efforts on these issues are insufficient.

The threats that agreements with for-profit management companies pose to nonprofit charter schools' tax-exempt status are under-deterred and infrequently addressed by the IRS and Department of Treasury. These government bodies should develop clearer guidelines for nonprofits to follow in their relationships with EMOs to provide charter school education, so as to help avoid potential revocation and taxation for excess benefit transactions among board members and other interested parties.

III. ARGUMENT

A. State Legislative and Judicial Gap-Filling

States that permit charter schools can be divided into two legal regimes: "restrictive" and "permissive." Under the latter, state statutes are either silent as to whether charter schools must operate as nonprofits, or they explicitly permit for-profit

62. See IRM 4.76.8.8 (July 1, 2003), available at http://www.irs.gov/irm/part4/irm_04-076-008.html#d0c619. See also, 2001 IRS NSAR 20010799R, 2001 WL 34818860 (Aug. 31, 2001); 2001 INS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001); 2000 IRS NSAR 20000753R, 2000 WL 34548359 (Oct. 30, 2000); 1997 IRS NSAR 0391, 1997 WL 33810247.

charter schools.⁶³ This means that a for-profit company could receive a charter and operate a publicly funded school for profit. Arizona is an example of a state with “permissive” charter school laws.⁶⁴

This paper addresses “restrictive” states, which require that a charter school operate as a nonprofit. Ohio and Pennsylvania are examples of “restrictive” states, where for-profit management companies have flourished and there has been comparatively significant litigation and legislative action concerning their role. Although, the issues of conflict of interest, board oversight, delegation, control and enforcement that emerge in “restrictive” regimes overlap in many ways, the discussion that follows attempts to break out three general areas where state legislatures and courts have grappled with tensions emerging from EMO agreements: (1) Conflict of Interest and Board Oversight; (2) Nonprofit Board Duties and Delegation; and (3) Standing, Enforcement and Attorneys General.

1. Conflict of interest and board oversight

Because nonprofit organizations are intended to provide oversight of the school’s operations and lead its governance in “restrictive” states, some legislatures have amended their laws to clarify nonprofit board members’ roles and to reduce opportunities for conflicts of interest. Conflicts emerge where there is overlap in representation on the board of the nonprofit and members of the EMO, or where there may be improperly close relationships between the two. Such ties threaten the accountability of charter schools by creating opportunities for self-dealing. While there are very few reported cases that address board oversight or self-dealing among charter school board members and management companies, Ohio offers an example.

In *Board of Trustees Sabis International School v. Montgomery*, the existing charter school board of directors brought an action, based on due process and equal protection theories, as well as state law contract and fraud claims, against the state charter-granting body, the school superintendent, the

63. Mead, *supra* note 50, at 362.

64. See ARIZ. REV. STAT. ANN. § 15-181(A) (2010).

attorney general, and the former board chair.⁶⁵ The claims were based on the alleged failure of the state defendants “to take certain action to protect” the nonprofit charter school from the “harmful” agreement with the management company entered into by the former board members.⁶⁶ The existing nonprofit board had sought help from the state in mediating a contract dispute between the school and the EMO under an arbitration clause in the school’s charter agreement with the government.⁶⁷

Conflict of interest on the nonprofit board had brought about the problems between the school and the management company. The former board chairwoman, who had led the decision to hire the company, had multiple family ties to the company’s leadership. (Her uncle founded the company and another relative was the current president.) As the board chair, she had been the sole board member to negotiate and sign all agreements with the management company, including a promissory note and a lease agreement, pursuant to which, the nonprofit paid the management company approximately \$98,000 per month for use of the school building.⁶⁸ When additional board members joined, the chairwoman was ousted and the remaining board members terminated the contract with the management company following the end of the current school year.

The management company claimed there were legitimate “disagreements over how to draw the line between the [nonprofit board’s] involvement with the school” and its own.⁶⁹ The company complained of the [board’s] “micro-management of the school.”⁷⁰

This case is an example of the need for clear rules to guide nonprofit charter school boards with regard to both self-dealing and oversight of management companies running the day-to-day school operations. In addition to the obvious conflict in hiring the company, the contract in *Sabis* provided for the

65. Bd. of Trs. *Sabis Int’l Sch. v. Montgomery*, 205 F. Supp. 2d 835 (S.D. Ohio 2002).

66. *Id.* at 842.

67. *Id.* at 840.

68. *Id.*

69. *Id.* at 840–41.

70. *Id.*

EMO to retain control of all of the school's financial records.⁷¹ This made subsequent efforts by the non-interested board members to exert oversight over the company difficult.⁷²

The court in *Sabis* ultimately dismissed all claims against the defendants and stated that the Ohio superintendant of education had no obligation under the charter school statute to “monitor or report on a school's service provider [management company].”⁷³ In a clear effort to hold the board squarely responsible for the failures of the school, the court wagged its finger at the plaintiffs, admonishing them that: “neither [the superintendant] nor anyone from her office encouraged the [b]oard to enter into the . . . [a]greement in the first place. The [b]oard made that decision independently, as it is permitted to do under Ohio law, and it cannot now fault the State.”⁷⁴ The result of the suit was that the charter school board had no remedy against anyone (including its self-dealing former board chair), and it had no more guidance than before the suit as to how to exert the kind of oversight and control the legislature and the court required of it.

Soon after this case, the Ohio state legislature passed a conflict of interest amendment to its charter school legislation.⁷⁵ Under the revised statutory scheme, nonprofit charter school boards must include “not less than five individuals who are not owners or employees, or immediate relatives of owners or employees, of any for-profit firm that operates or manages a school.”⁷⁶ A more recently revised version of the law goes even further to root-out conflict of interest, stating, “[N]o present or former member, or immediate relative of a present or former member, of the [nonprofit charter school board] shall be an owner, employee, or consultant of any nonprofit or for-profit operator of a community school, unless at least one year has elapsed since the conclusion of the person's membership.”⁷⁷

Nothing in the statute, however, outlines the terms that boards should negotiate in contracts with management

71. *Id.*

72. *Id.* at 841.

73. *Id.* at 851–52 (interpreting OHIO REV. CODE ANN. § 3314.12).

74. *Id.* at 852.

75. *Id.* (referencing the former language of OHIO REV. CODE ANN § 3314.02(E)).

76. *Id.*

77. OHIO REV. CODE ANN. § 3314.02(E)(3) (2009).

companies, or defines the respective roles of boards and companies to prevent “micro-managing” or inappropriate delegation. Should the state permit the contract to include *any* terms to which the parties agree where savvy management companies, who have explicit strategies to limit client involvement, are negotiating with nonprofit charter school boards, who may be made up of community members, parents and teachers? This assumes an equity in bargaining power that does not exist. Arguably, apart from the conflict of interest issue in board membership, the charter school in *Sabis* should not have become the recipient of a promissory note from the management company, nor become its lessee. These ancillary relationships reduced the ability of the board to negotiate with the company from a position of strength solely as a client or customer, and provided disincentives to challenging any of the company’s decisions or practices. Nonetheless, EMOs routinely obtain and control school facilities, using “debt and real estate to bind schools to it.”⁷⁸ Statutes that more explicitly detail the scope of the relationship between nonprofit boards and EMOs and perhaps provide model contract language, would have guided the board to exert more effective control in *Sabis*. Alternatively, removing real estate from the relationship altogether may be more effective. Cities like Washington, D.C. and New York work with charter schools to obtain buildings, which means that management companies do not control this significant asset.⁷⁹

2. *Charter school nonprofit board duties and delegation*

Pennsylvania has the most charter school litigation of any state.⁸⁰ These cases explore the appropriate level of control a charter school board should exert over a management company, and at what point the nonprofit has become nothing more than a shell for the for-profit. In *Carbondale Area School District v. Fell Charter School*, a community of residents created a nonprofit organization and applied for a charter so they could keep a school in their neighborhood after the state authority had closed the local public school and consolidated

78. Strom, *supra* note 2.

79. *Id.*

80. Mead, *supra* note 50.

the district.⁸¹ In its application, the community stated that it planned to contract with the for-profit management company Mosaica Education Inc.⁸² to oversee the day-to-day operation of the charter school. The state authority denied the application because, *inter alia*, it found that the community nonprofit board would be “nothing more than a rubber stamping body” for Mosaica.⁸³ Specifically, the state authority suggested that the nonprofit board had delegated an impermissible number of responsibilities to Mosaica, including:

(1) preparation of the annual budget, (2) maintenance and retention of all financial and student records, (3) recommendation and enforcement of rules, regulations, and procedures . . . (4) solicitation and receipt of grants and donations . . . (5) selection, evaluation, assignment, discipline, supervision, and transferring of [the school’s] personnel, (6) determination of [the school’s] staffing level, (7) selection and employment of the [school’s] principal, and (8) providing [the school] with Mosaica’s copyrighted Paragon curriculum.⁸⁴

The community nonprofit appealed to the state charter school appeal board, which reversed the lower state authority’s decision and directed it to grant the charter.⁸⁵ The state authority refused and petitioned the state court for review.⁸⁶ The court looked to the Pennsylvania charter school statute⁸⁷ using the analysis it developed in *West Chester Area School District v. Collegium Charter School*, which involved another charter school managed by Mosaica.⁸⁸ The court stated:

Clearly . . . the legislature did not want to entrust the management and operation of the charter school itself to entities seeking to make money from the schools management and operation; rather, that power is granted to the charter

81. *Carbondale Area Sch. Dist. v. Fell Charter Sch.*, 829 A.2d 400, 402 (Pa. Commw. Ct. 2003).

82. Mosaica Education is a for-profit charter school “operator” whose current executive management is made up of private equity and management consultant alumni. MOSAICA EDUCATION, <http://mosaicaeducation.com/about-mosaica/>.

83. *Carbondale Area Sch. Dist.*, 829 A.2d at 406.

84. *Id.*

85. *Id.* at 402.

86. *Id.* at 402-03.

87. PA. CONS. STAT. ANN § 17-1719-A(4) (West 2009).

88. *W. Chester Area Sch. Dist. v. Collegium Charter Sch.*, 760 A.2d 452 (Pa. Commw. Ct. 2000).

school's board of trustees who . . . have a single purpose to promote the interests of pupils.⁸⁹

The issue, according to the court, is whether the charter school's board will have a "real and substantial authority and responsibility for the educational decisions, and the teachers are employees of the charter school itself."⁹⁰

Ultimately, the court affirmed the appeals board, holding that the delegation of administration outlined in the Mosaica agreement was permissible, and that the charter would not prevent the nonprofit board from "exercising ultimate control of the charter school."⁹¹ The *Carbondale* court's holding mirrors that of several other Pennsylvania cases challenging the delegation of charter school control to for-profit management companies.⁹² In all of these cases, the suspicions of local school districts that refused to grant charters to nonprofits working with management companies were dismissed by administrative boards of appeals and the courts.

These cases are illustrative of the dissonance between the legislature's expectations and the realities of many charter schools. While nonprofit boards are intended to promote accountability and play an active role in ensuring profit motives do not undermine educational goals, *Carbondale*, and the other Pennsylvania cases, stand for the proposition that boards may relinquish a school's actual fiscal, personnel, and even curricular decision-making to a for-profit company, as long as the contract states that the nonprofit board maintains "ultimate control."⁹³ These decisions are especially revealing considering that the Pennsylvania charter school law is robust, and includes specific language about the required sphere of

89. *Carbondale Area Sch. Dist.*, 829 A.2d at 402.

90. *Id.*

91. *Id.*

92. *Sch. Dist. of York v. Lincoln-Edison Charter Sch.*, 798 A.2d 295 (Pa. Commw. Ct. 2002) (affirming appeals board reversal of school district and directing the grant of a charter to a nonprofit contracting with the Edison School Inc. management company); *Brackbill v. Ron Brown Charter Sch.*, 777 A.2d 131 (Pa. Commw. Ct. 2001) (affirming appeals board reversal of school district and directing the grant of a charter to a nonprofit contracting with Mosaica); *W. Chester Area Sch. Dist.*, 760 A.2d 452 (Pa. Commw. Ct. 2000) (affirming appeals board reversal of school district that concluded nonprofit was not an independent, public, non-profit corporation, but in fact, a profit-making conduit for the management company Mosaica, and directing the grant of the charter).

93. *Carbondale Area Sch. Dist.*, 829 A.2d at 407; see also *Brackbill*, 777 A.2d at 137.

nonprofit charter school board responsibilities.⁹⁴ Nonetheless, the courts refuse to move beyond the scope of the contract language to determine and ensure that actual board activities will not, in fact, act as a “rubber stamp” for the management company.

3. *Standing, enforcement and attorneys general*

The relatively small amount of charter school litigation in “restrictive” states, including Pennsylvania and Ohio, may be related to limits with regard to who may bring suits. In Pennsylvania, the school districts that refuse to grant a charter have standing to challenge the nonprofit charter school and its for-profit management company if the school subsequently wins the right to a charter on appeal. Other constituencies have sought to challenge EMOs by challenging the nonprofits that hire them to manage their schools. Tax-payers⁹⁵ and neighboring school districts,⁹⁶ who have argued that charter grants to nonprofit groups which have contracted with EMOs were improper or that their funds are being diverted to, essentially for-profit schools, have failed because courts have refused to grant standing. Courts have held that charter school statutes prohibit even the state department of education from bringing suit to enforce the obligations of charter school boards.⁹⁷ This limits the enforcement power of the courts to actions brought by charter-granting school districts, which appear to be uniformly overruled by the Pennsylvania courts to date.

94. The Pennsylvania statute reads:

Powers of board of trustees (a) The board of trustees of a charter school shall have the authority to decide matters related to the operation of the school, including, but not limited to, budgeting, curriculum and operating procedures, subject to the school's charter. The board shall have the authority to employ, discharge and contract with necessary professional and nonprofessional employees [sic] subject to the school's charter and the provisions of this article. . . . (c) The board of trustees shall comply with the act of July 3, 1986 (P.L. 388, No. 84), known as the ‘Sunshine Act.’

PA. CONS. STAT. ANN. § 17-1716-A.

95. See, e.g., *Fairfield Area Sch. Dist. v. Nat'l Org. for Children, Inc.*, 837 A.2d 644 (Pa. Commw. Ct. 2003); *Brackbill*, 777 A.2d 131; *W. Chester Area Sch. Dist.*, 760 A.2d 452.

96. *Fairfield*, 837 A.2d at 644; *Pa. Sch. Bds. Ass'n v. Zoghy*, 802 A.2d 6 (Pa. Commw. Ct. 2002).

97. *Zoghy*, 802 A.2d 6.

Traditionally, enforcement of nonprofit law has been the purview of the state attorney general.⁹⁸ In Ohio, however, the courts recently ruled that charter schools, which must be run as nonprofits as a matter of state law, are immune from attorney general oversight.⁹⁹ While the suit did not include a for-profit management company, it did involve claims that the nonprofit charter school board was not meeting its obligations. The Ohio attorney general brought an action against the board based on a charitable trust theory, alleging that the board failed to meet “fiduciary duties with regard to the public moneys it has received.”¹⁰⁰ According to the attorney general, the arrangement between the state, the charter school board, and the public was structured as a trust. “The [s]tate (settlor) provides funds to [the charter school] (the trustees) for the benefit of . . . students and the general public (the beneficiary).”¹⁰¹ The action sought to either terminate the trust or replace the board members.¹⁰²

The court ruled that as a charter school, the organization was no longer merely a nonprofit, but a “political subdivision and a legislatively-created public school falling within the state’s system of public education and the oversight of the Department of Education.”¹⁰³ As such, it was not subject to the oversight of the state attorney general. Without attorney general oversight, the charter schools of Ohio are subject only to the control of their sponsoring district board of education (like Pennsylvania), and parents, who may vote with their feet by removing students from the school.

Outside of nonprofit law, state contract law might provide nonprofit board members a framework for exerting control over overbearing EMOs. However, upon quick reflection, it is apparent this is unlikely. Where EMOs have created boards with members whose interests align with the EMOs, the nonprofit charter board is not likely to sue to enforce the terms

98. See Jeremy Benjamin, Note, *Reinvigorating Nonprofit Directors’ Duty of Obedience*, 30 CARDOZO L. REV. 1677, 1697–98 (2009) (asserting that only state attorneys general have standing in cases involving a nonprofit director’s fiduciary breach).

99. State *ex rel.* Rogers v. New Choices Cmty. Sch., No. 23031, 2009 WL 2857360, at *12 (Ohio Ct. App. Sept. 4, 2009).

100. *Id.* at *3–4.

101. *Id.* at *4.

102. *Id.* at *4–5.

103. *Id.* at *9.

of the agreement where they upset an arrangement that serves the EMO. If, as in Ohio, the courts have found charter schools and their boards immune from attorney general investigation, there are no legal options to protect the charter school from becoming a mere alter ego of the EMO.

B. Risks Facing Nonprofit Charter Schools Under the Internal Revenue Code

In addition to state law prohibitions, the relationship between a nonprofit charter school board and its for-profit management company has implications for the nonprofit's tax-exempt status under federal law.¹⁰⁴ According to its manual, the IRS recognizes the complex and interdependent relationships that may exist in charter school formation.¹⁰⁵ When considering the tax-exempt status of new or existing nonprofits that are working with for-profit companies, it cautions examiners that:

Organizations . . . operating schools under a charter agreement, may have little or no experience in managing or establishing a school and often contract for a myriad of services including, among others, curriculum design, financial management, office management, and special education services. Comprehensive school management companies are a growing presence in the educational sector and offer a complete program of both management and educational services. For a charter school to establish exemption under IRC § 501(c)(3), whether it contracts out some or all of the services required to operate, it must establish that it is organized and operated for exclusively charitable purposes and not for the benefit of private management companies and/or for service providers.¹⁰⁶

The IRS is interested in whether the charter school board remains in control and continues to exercise its fiduciary responsibility to the school.¹⁰⁷ A board appointed or dominated

104. JAMES J. FISHMAN & STEPHEN SCHWARTZ, *NONPROFIT ORGANIZATIONS CASES AND MATERIALS* 596 (3d ed. 2005).

105. IRS MANUAL 4.76.8.8—CHARTER SCHOOLS (July 1, 2003) WL (RIA-IRM).

106. IRS MANUAL 4.76.8.8.1(3)—CHARTER SCHOOLS EXEMPT STATUS (July 1, 2003) WL (RIA-IRM).

107. TERRY BERKOVSKY, ANDREW MEGOSH, DEBRA COWEN & DAVID DAUME, *CHARTER SCHOOLS, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FY 2000*, 2000 WL 34402222 (I.R.S.), available at <http://www.irs.gov/pub/irs-tege/cotopicj00.pdf>.

by a management company raises questions as to whether the school will be operated for the benefit of the management company.¹⁰⁸ The IRS will not grant tax-exempt status where a nonprofit charter school board has delegated its responsibility and ultimate accountability for the school's operations to a for-profit management company.¹⁰⁹

1. Charitable purpose, delegation and conflict of interest

There are only four published IRS Service Advice Reviews ("SARs") that discuss nonprofit charter school relationships with for-profit management companies, but the discussions are searching and indicate that the IRS has much higher standards for schools than the courts under state charter school legislation.¹¹⁰ The IRS decisions also reveal more scrutiny of the history and players behind the creation of the nonprofit charter school, as well as the board's actual ability to operate in light of the contract with the management company.¹¹¹ Perhaps it is revealing that all four of the SARs deny tax-exempt status to the nonprofit schools because of their connections with management companies.¹¹² The decisions focus on three areas: (1) the management company's role in creation of the nonprofit and its board independence, (2) the terms of the agreement with the for-profit and the degree of delegation, and (3) the benefits flowing to the for-profit company.

The earliest decision appears to be from 1997, denying tax-exempt status to a kindergarten through sixth grade charter school with a "business and entrepreneurial" theme.¹¹³ The IRS relied on the fact that the management company's principal incorporated the nonprofit charter school, established its board, made the application to the state for the grant of a charter, and established the scope of the curriculum.¹¹⁴

108. *Id.*

109. *Id.*

110. *See, e.g.*, 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001); 2001 IRS NSAR 20010799R, 2001 WL 34818860 (Aug. 31, 2001); IRS NSAR 20000753R, 2000 WL 34548359 (Oct. 30, 2000); 1997 IRS NSAR 0391, 1997 WL 33810247.

111. *Id.*

112. *Id.*

113. 1997 IRS NSAR 0391, 1997 WL 33810247.

114. *Id.*

Members of the charter school's board included the management company principal.¹¹⁵

The IRS also detailed the terms of the management agreement, and deemed that the nonprofit had abdicated its oversight role by permitting the management company to oversee: curriculum development and the acquisition of instructional materials, supplies and equipment; all extracurricular activities; hiring, firing and professional development of personnel; maintenance of the school facilities, including transportation and food; all school "business" opportunities and finances, and "any other function necessary or expedient for the administration of the school."¹¹⁶ The IRS also appeared suspicious of the terms of renewal, which were automatic on an annual basis and did not require meeting any specific performance measures or other obligations of the nonprofit board.¹¹⁷ Termination could only occur if the nonprofit board gave written notice in advance of the new school year. In addition to the contract to manage the school, the management company and the charter school were further entangled in a lease agreement and promissory note that made the nonprofit a tenant of and debtor to the management company.¹¹⁸

The IRS concluded that the "business and entrepreneurial" charter school was created with a "dual purpose of operating an educational organization and providing business to" the management company.¹¹⁹ It further held that even though the original board members (who were clearly interested parties with ties to the management company) had been replaced, the "new board" of the nonprofit had been appointed by the old board, and demonstrated no increased independence.¹²⁰ The IRS noted that the "new board" had taken no steps to review the management agreement, and appeared to be no more than a "rubberstamp of the status quo."¹²¹ In a final blow, the IRS stated that "even assuming . . . [the nonprofit board of directors] are independent, . . . the management agreement

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

gives [the for-profit] impermissible control of [the school's] operations. . . . [and] in effect, handed the keys [of its] operations to a for-profit management company, one which has been intimately tied to [it] since [its] formation."¹²²

Perhaps the most insightful part of the IRS decision is the acknowledgement of the business model behind charter school management companies that drives its relationships with nonprofit boards. The IRS noted that in the case of the "business and entrepreneurial" charter school, the benefit clearly flowed to the for-profit, as the company was able to "create its own customer, eliminate competition, . . . experiment and gain competence with [the] students, . . . [and] improve its intellectual property" by setting up the nonprofit and negotiating the contract to run the school.¹²³ This was evidence that the benefits flowing to the for-profit were more than merely "incidental,"¹²⁴ and prevented the nonprofit charter school from attaining tax-exempt status.

The other cases are variations on the same themes. In the decision to deny tax-exempt status to a charter school for the "deaf and hard of hearing," the IRS discussed the issue of conflict of interest and "arms-length" dealings, explicitly.¹²⁵ In this case, the management company's principal (who apparently created a company that specialized in the education of the deaf) helped to incorporate the nonprofit charter school and sat on the nonprofit's board at the time it signed the management contract with his company.¹²⁶ Incredulous, the IRS noted that the lack of board policies on the issue, and the terms of the contract (which were "general" and "silent as to how the budget will be negotiated") reveal that there was no attempt to operate at "arms-length."¹²⁷ Indeed, the IRS was so troubled by the language of the contract, which made no mention of the charitable nature of the school to be managed, that it suggested the board had permitted the company "to maximize profit" at the expense of the school.¹²⁸ The IRS found

122. *Id.*

123. *Id.*

124. *Id.*

125. 2000 IRS NSAR 20000753R, 2000 WL 3458359 (Oct. 30, 2000).

126. *Id.*

127. *Id.*

128. *Id.*

that the nonprofit had become a captive, powerless party to a “one-sided” “adhesion contract” with its founder’s company.¹²⁹

In two cases, a management company was contractually authorized not only to manage the school, but to renegotiate the school’s charter with the charter-granting government organization or sponsor.¹³⁰ This reduced the nonprofit board’s role to merely *not terminating* the annual agreement with the management company, as no other board activity appeared to be required.¹³¹ Without notice from the board, the company would continue indefinitely to manage all finances, run school operations, and ensure a valid government charter by executing the renewal with the authorities, when required by statute, to keep public funds flowing.¹³²

In another decision, the IRS held that a nonprofit charter school, developed as an adjunct to a newly planned housing community, had “retained little, if any, ability to create an identity for [itself] by allowing [the management company] to act as a buffer between [the school] and the people [it was] supposed to be serving: students, parents, teachers and the general public.”¹³³ In this case, the board had “contracted away” the obligations to create marketing plans and handle public relations for the school, create and manage parent-teacher programs, as well as dictate student curriculum and instruction.¹³⁴ The same agreement included a non-compete clause, preventing any of the employees of the school (who worked for the company) from working for the nonprofit for one year.¹³⁵ This restricted the oversight of the nonprofit board enormously, with the termination of the agreement resulting in the need to completely reassemble the school’s staff.¹³⁶ The IRS characterized the relationship between the nonprofit and the management company as being like a “franchise,” where the nonprofit board was controlled by the management company, which dictated everything about how the school

129. *Id.*

130. 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001); 2001 IRS NSAR 20010799R, 2001 WL 34818860 (Aug. 31, 2001).

131. 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001)

132. 2001 IRS NSAR 20010799R, 2001 WL 34818860 (Aug. 31, 2001).

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

would function, and from whom the board would have to purchase all the related curriculum and materials.¹³⁷ The contract made the company indispensable to the very existence of the school.

2. *Excess benefit transactions*

None of the IRS opinions impose tax liability because the Service does not grant tax-exempt status to any of the charter schools. However, one opinion discussed the threat of intermediate sanctions for excess benefit transactions in light of the arrangements between the school and its management company.¹³⁸ According to the decision, the “deaf and hard of hearing” school’s officers, directors and management company would have likely faced tax liability under Section 4958,¹³⁹ because of the management company’s “substantial influence over” the school, its “manipulation of [the] contract negotiations” and the “excessive nature of the benefits flowing to” the company.¹⁴⁰ Considering the potential for excess benefit transactions in the charter school setting where there is board overlap between the school and its management company, it is regrettable that the IRS has not addressed the issue in its published guidelines for nonprofit charter schools.¹⁴¹

IV. CONCLUSION

The number of charter schools continues to grow in many states.¹⁴² For-profit education management companies will continue to serve this market. However, lessons learned by management companies over the last two decades reveal that operating charter schools is “more difficult and more expensive than [companies] anticipated.”¹⁴³ This is, according to the companies, a result of “charter school opponents [who] have been able to impose high political and legal costs on these

137. *Id.*

138. IRS NSAR 20000753R, 2000 WL 34548359.

139. 26 U.S.C. § 4958 (2010).

140. IRS NSAR 20000753R, 2000 WL 34548359.

141. BERKOVSKY, ET AL., *supra* note 108.

142. *See, e.g.*, S.R. A11310 (N.Y. 2010).

143. NAT’L CHARTER SCH. RESEARCH PROJECT, *supra* note 5, at 3.

organizations.”¹⁴⁴ Economies of scale have driven industry consolidation, as companies like Mosaica, Chancellor Beacon Academies, Charter Schools USA, Edison Schools, and White Hat Management have displaced other, smaller management companies, and now operate multiple school sites, often in different parts of the country, from a centralized office.¹⁴⁵ This is not unlike a franchise business model. In the face of shrinking profits and scrutiny from political leaders and the press,¹⁴⁶ management companies are becoming more selective about “client acquisition.”¹⁴⁷ This does not bode well for nonprofit charter school boards. For-profit management companies will always seek ways to maximize control to ensure efficiency and profit. This includes driving the creation of a charter school from application to contract negotiation to subsequent charter renewal, where possible. Indeed, doing so, according to management company leaders themselves, is essential to success.¹⁴⁸

In light of the negotiating power and motivations of management companies, the threat of nonprofit charter school board capture or inappropriate delegation comes into sharp focus. Because courts have shown themselves unwilling to proscribe clear rules and appear to be generally overly permissive with regard to charter school boards, more guidance must flow from the legislative and executive branches. State charter school law and IRS guidelines should be strengthened, clarified and harmonized to promote stronger board autonomy and accountability. The opportunity for abuse, in light of the limitations for oversight and enforcement from government and other parties, demands express directives for charter schools. The consequences of failure to govern can be catastrophic, including revocation of tax-exemption, imposition of tax liability, revocation of charter, and the loss of public trust, and therefore call for *ex ante* rules to guide board activity at every stage.

The unintended consequences of increased rule making may be to chill the project of charter school creation, however it will strengthen the (arguably reduced number of) organizations

144. *Id.* at 7.

145. *Id.* at 17.

146. *Id.* at 4.

147. *Id.* at 6.

148. *Id.*

that are granted charters by making them less vulnerable to for-profit control, and resulting state or federal sanction. Critics of further rule-making argue that freeing charter schools from many of the regulations that constrain traditional public schools is a central precept of the movement that promotes innovation and experimentation. But, where management companies bring an existing “tested” and all-inclusive “product” to charter schools (including facilities, staff and curriculum), it would seem that some increased regulation does little to undermine “innovation.”

Specifically, state charter school laws should, at a minimum, include the following directives:

(1) Specify non-delegable duties for nonprofit boards, including fiscal management and maintenance of financial record-keeping that a contracting EMO may not conduct;

(2) Require charter school boards to adopt conflict of interest / self-dealing policies for board membership that prevent board members who are employees or have any financial ties to a contracting EMO;

(3) Require the nonprofit board (and prohibit the management company) to seek state charter renewal;

(4) Prohibit certain terms in agreements between charter school boards and management companies, including auto-renewal without performance-based outcomes and board active review and decision-making;

(5) Prohibit non-compete clauses for teachers and charter school staff when they are employees of the management company;

(6) Prohibit or restrict ancillary agreements for loans and facilities that entangle charter school boards with management companies and diminish incentive and opportunity for active oversight; and,

(7) Require boards to conduct a review and reveal any conflict of interest between board members and a contracting EMO before a charter is granted or renewed to avoid boards becoming management companies’ alter egos.

In addition, the IRS should provide detailed guidance, perhaps in an updated Technical Instruction Program, that summarizes its SARs to date and elaborates on less flagrant and extreme activities of nonprofits and management companies to help charter schools attain and retain their nonprofit status, as well as avoid tax liability for excess benefit

transactions. The Service should address the creation of “shell” nonprofits by management companies, as well as less egregious relationships. Charter schools need to understand how to structure relationships with a for-profit management company, and specifically which functions the IRS will require them to retain. Failing to do so leaves charter school boards in a perilous position, simultaneously under-prepared to negotiate with the management company, and the party who bears the risk for failure to comply with IRS obligations for tax-exempt status.