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## Are Charter Schools the Second Coming of Enron?: An Examination of the Gatekeepers that Protect Against Dangerous Related-Party Transactions in the Charter School Sectors

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# **Are Charter Schools the Second Coming of Enron?: An Examination of the Gatekeepers That Protect Against Dangerous Related-Party Transactions in the Charter School Sector\***

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## INTRODUCTION

In December 2001, Enron rocked the financial world by declaring bankruptcy due to the effects of an accounting scandal. Earlier in the year, Enron had been the seventh largest corporation in the country.<sup>1</sup> This energy trading and utilities giant had become a dominant player by aggressively benefitting from the federal deregulation of the energy markets.<sup>2</sup> Enron's collapse erased more than \$60 billion in shareholder value and caused thousands of employees to lose their jobs and pensions.<sup>3</sup>

Enron proved not to be an anomaly. Soon after the corporation's collapse, the financial markets were further roiled when WorldCom, Adelphia, and Tyco, among others, declared bankruptcy because of accounting fraud.<sup>4</sup> Congress responded to this wave of scandals by passing the Sarbanes-Oxley Act of 2002, which imposed greater accountability on publicly traded companies and their auditors.<sup>5</sup>

Andrew Fastow, Enron's CFO, was a pivotal figure in Enron's collapse. He created two special purpose entities (SPEs)—LJM1 Cayman LP (LJM1) and LJM2 Co-Investment LP (LJM2)—to serve as a hedge against potential downturns in Enron stock.<sup>6</sup> Fastow and his associates served as the managers of these SPEs.<sup>7</sup> Because of Fastow's dual management roles, Enron should have disclosed to its shareholders that the partnerships were related-party transactions, defined as deals between entities with special, preexisting relationships,<sup>8</sup> which Enron failed to do.<sup>9</sup> Although related-party transactions are legal, they can create conflicts of interest that have the potential of harming their shareholders.<sup>10</sup> Specifically, these transactions “can create the impression that an insider is using company assets for personal benefit, and that

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1. Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 9 (2002).

2. See John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 64 (2005).

3. Steve Hargreaves, *Ex-Enron Workers: Keep Skilling in Prison*, CNN MONEY (May 10, 2013, 6:33 AM), <http://money.cnn.com/2013/05/10/news/companies/enron-skilling> [<https://perma.cc/3QYK-S6K8>].

4. Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 127 (2002).

5. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

6. W. STEVE ALBRECHT, CHAD O. ALBRECHT, CONAN C. ALBRECHT & MARK F. ZIMBELMAN, *FRAUD EXAMINATION* 440–41 (5th ed. 2016).

7. *Id.*

8. *Related-Party Transaction*, INVESTOPEDIA, <http://www.investopedia.com/terms/r/related-partytransaction.asp> [<https://perma.cc/2WAV-WEM7>].

9. See ALBRECHT ET AL., *supra* note 6, at 441.

10. Elizabeth A. Gordon, Elaine Henry & Darius Palia, *Related Party Transactions and Corporate Governance*, 9 ADVANCES IN FIN. ECON. 1, 7 (2004) (explaining the conflict of interest view of related-party transactions).

the company is getting the short end of the stick.”<sup>11</sup> Indeed, Fastow did take advantage of this conflict of interest by making millions of dollars from the SPEs and using the illegal proceeds to invest in other interests.<sup>12</sup>

Enron’s collapse was significant because it exposed the deficiencies of gatekeepers that had the responsibility of protecting the integrity of the markets.<sup>13</sup> These gatekeepers included Enron’s auditor Arthur Andersen, independent analysts, credit rating agencies, corporate boards, and the Securities and Exchange Commission (SEC).<sup>14</sup> In the case of the Enron debacle, all of these watchdogs failed to detect the dangers caused by Fastow’s conflict of interest.

Related-party transactions are now posing a threat to the charter school sector. Charter schools are a deregulated departure from traditional public schools because they are exempted from laws governing budgets and financial transparency.<sup>15</sup> Similar to Fastow, unscrupulous individuals and corporations are using their control over charter schools and their affiliates to obtain unreasonable management fees for their services and funnel money intended for charter schools into other business ventures.<sup>16</sup>

In spite of this evidence, the federal government has consistently attempted to increase the number of charter schools without pushing for oversight.<sup>17</sup> This policy approach is alarming because it will create more opportunities for illegal related-party transactions.<sup>18</sup> Also, this approach runs the risk of harming students in low-income and minority communities—the very children whom charter schools are supposed to serve.<sup>19</sup> Therefore, charter school gatekeepers must learn from the Enron debacle by becoming more prepared to guard against the dangers posed by related-party transactions.<sup>20</sup> These gatekeepers include auditors, governing boards, authorizers, state education agencies (SEAs), and the U.S. Department of Education.

In this Article, we discuss how some charter school officials have engaged in Enron-like related-party transactions to defraud charter schools. We also identify

11. Peter Loftus & Marcelo Prince, *Even Good Insider Deals Raise Doubts*, WALL ST. J. (May 7, 2003).

12. Mark P. Holtzman, Elizabeth Venuti & Robert Fonfeder, *Enron and the Raptors*, 73 CPA J. 24, 25 (2003).

13. See, e.g., Marianne M. Jennings, *A Primer on Enron: Lessons from A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Cultural Failures*, 39 CAL. W. L. REV. 163 (2003); Kroger, *supra* note 2; Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394 (2004).

14. Kroger, *supra* note 2, at 59–60 (identifying auditors, independent analysts, corporate boards, and the SEC). Kroger does not include credit rating agencies as gatekeepers, but acknowledges that many commentators do. *Id.* at 60 n.12. Other commentators include Macey, *supra* note 13, at 403 and David Millon, *Who “Caused” the Enron Debacle?*, 60 WASH. & LEE L. REV. 309, 313 (2003).

15. Tomiko Brown-Nagin, *Toward a Pragmatic Understanding of Status-Consciousness: The Case of Deregulated Education*, 50 DUKE L.J. 753, 765 (2000).

16. See *infra* Part III.

17. See *id.*

18. See *id.*

19. See *infra* Part IV.

20. See *id.*

several measures that can be taken to strengthen the ability of charter school gatekeepers to protect against this danger. This Article is divided into four Parts. Part I describes how Fastow used his management of Enron and the SPEs to obtain illegal profits contrary to the interests of the former company. Part II discusses why the gatekeepers in the financial sector failed to stop the related-party transactions between Enron and the LJM entities. Part III provides examples of how individuals in the charter school sector are benefitting from their control over charter schools and their affiliates in a manner similar to Fastow. Part IV analyzes, inter alia, pertinent statutory and regulatory provisions that apply to state and federal gatekeepers. We perform this task to identify the steps that legislators and policymakers can take to increase the gatekeepers' ability to protect against harmful related-party transactions.

## I: OVERVIEW OF ENRON

### A. *Enron and Deregulation*

Enron's business model took advantage of the federal deregulation of the energy markets. Prior to deregulation, the Federal Energy Regulatory Commission (FERC) had set rates for the production of gas pipelines and gas wells.<sup>21</sup> The price regulation of the competitive gas production sector had created shortages in natural gas production in the late 1960s.<sup>22</sup> In response to the energy crisis of the 1970s, Congress passed the National Energy Act of 1978.<sup>23</sup> A key provision of the statute deregulated natural gas prices to encourage more natural gas production.<sup>24</sup>

Enron recognized that the newly deregulated natural gas industry was grossly inefficient because producers struggled to identify and contract with potential customers.<sup>25</sup> Enron addressed this problem through the creation of the "gas bank."<sup>26</sup> The gas bank matched buyers of natural gas, who wanted to lock in current prices for future delivery, with producers who wanted to ensure that they had customers in the future.<sup>27</sup> Enron made substantial profits because producers and users stopped trying to enter the market, but instead, decided to deal with Enron.<sup>28</sup>

Enron then tried to replicate its success with the gas bank by pouring billions of dollars into other sectors.<sup>29</sup> This diversification strategy failed, however, because Enron used approaches that succeeded in the gas sector, instead of hiring managers with business experience in these new areas.<sup>30</sup> As a result, by the late 1990s, Enron

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21. Jacqueline Lang Weaver, *Can Energy Markets Be Trusted? The Effect of the Rise and Fall of Enron on Energy Markets*, 4 HOUS. BUS. & TAX L.J. 1, 7–8 (2004).

22. *Id.* at 8.

23. *Id.*

24. *Id.*

25. Kroger, *supra* note 2, at 64.

26. *Pride at Root of Skilling's Downfall*, USA TODAY (Oct. 24, 2006, 4:32 AM), [http://usatoday30.usatoday.com/money/industries/energy/2006-10-23-skilling-profile-usat\\_x.htm](http://usatoday30.usatoday.com/money/industries/energy/2006-10-23-skilling-profile-usat_x.htm) [<https://perma.cc/4Q3C-MGKU>].

27. *Id.*

28. Kroger, *supra* note 2, at 64.

29. *Id.* at 65.

30. *Id.* at 66.

had lost more than \$10 billion in cash. Enron exacerbated its financial problems by spending extravagantly on personnel costs.<sup>31</sup>

### B. The LJM SPEs

To bankroll the company's profligate spending on diversification and personnel, Enron used multiple strategies to improve its credit rating, while hiding its true economic position from the company's lenders.<sup>32</sup> One tactic involved the creation of SPEs, which are entities that are designed to fulfill specific legal purposes.<sup>33</sup> Enron's SPEs were conceived to remove debt from its holdings.<sup>34</sup> Fastow oversaw two SPEs—LJM1 and LJM2—which played a major part in Enron's downfall.<sup>35</sup> LJM1 protected the profits that Enron had gained from a transaction with a high-speed internet provider named Rhythms NetConnections ("Rhythms").<sup>36</sup> LJM2 was a larger version of LJM1.<sup>37</sup> LJM2 also invested in another group of SPEs, known as the "Raptors," to serve as additional hedges.<sup>38</sup> Both LJM transactions used Enron stock, which was doing very well at the time, as a hedge against the potential collapse of Enron's assets.<sup>39</sup> Fastow's stewardship of LJM entities required Enron's Board of Directors to waive its code of ethics, which prohibited Enron employees from engaging in activities that would conflict with its interests.<sup>40</sup>

To avoid classification as subsidiaries, which would have forced Enron to consolidate the SPEs into the company's financial statements, an independent owner had to exercise control of the SPEs.<sup>41</sup> The LJM entities failed this requirement because Fastow exercised control over their operations.<sup>42</sup> Fastow benefited greatly from his self-dealing. In fact, over a two-year period, Fastow received more than \$30 million in management fees from these entities.<sup>43</sup>

Fastow also conspired with others to use LJM1 to enrich himself at the expense of Enron's shareholders. Because of a dramatic increase in the value of Enron stock, the value of the hedge also rose sharply.<sup>44</sup> Fastow responded by creating a scheme that enabled him and his fellow co-conspirators to pocket \$30 million.<sup>45</sup> Some of the

31. *Id.* at 67.

32. *Id.* at 68–69.

33. Holtzman et al., *supra* note 12, at 26.

34. Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. 1309, 1309–10 (2002).

35. ALBRECHT ET AL., *supra* note 6, at 441.

36. *Id.*

37. *Id.*

38. Milton C. Regan, Jr., *Teaching Enron*, 74 FORDHAM L. REV. 1139, 1213 (2005).

39. *Id.*

40. *Id.* at 1238.

41. ALBRECHT ET AL., *supra* note 6, at 440.

42. *Id.* at 441.

43. Kroger, *supra* note 2, at 96.

44. See DENIS COLLINS, BEHAVING BADLY: ETHICAL LESSONS FROM ENRON 85–86 (2006).

45. *Id.*

funds went to an SPE that Fastow created, called Southampton Place (\$11.7 million).<sup>46</sup> Later, Fastow distributed \$4.5 million of these funds to his eponymous family foundation, which had invested \$25,000.<sup>47</sup>

### *C. Enron's Collapse*

Enron's hedging scheme was fundamentally flawed because it failed to anticipate the possibility that Enron's stock would fall at the same time as the stock held by the LJM entities.<sup>48</sup> However, that is exactly what happened to the Raptors. Consequently, the Raptors incurred huge credit shortfalls.<sup>49</sup> The Raptors were further flawed by an accounting mischaracterization. In exchange for the loan of Enron stock, the Raptors gave Enron promissory notes totaling \$1 billion.<sup>50</sup> Enron mischaracterized the promissory notes as assets, thus wrongly increasing shareholders' equity by \$1 billion.<sup>51</sup>

In August 2001, Enron and its auditor Arthur Andersen realized the accounting error.<sup>52</sup> Enron responded by terminating the Raptors.<sup>53</sup> This termination required Enron to repurchase the shares it had lent the Raptors at a cost of \$1 billion in shareholder equity.<sup>54</sup> Also, Enron wrote off an additional \$200 million due to losses on stock investments made by the Raptors.<sup>55</sup> On October 16, Enron reported the reduction of \$1.2 billion in shareholder equity, along with \$1.01 billion in losses from bad investments.<sup>56</sup> Enron's declarations undermined investor confidence, causing Enron's stock to plummet. Six weeks later, Enron declared bankruptcy.<sup>57</sup>

## II: ENRON'S GATEKEEPER PROBLEMS

### *A. Arthur Andersen*

A number of gatekeepers had the responsibility of protecting shareholders from Enron's illegal related-party transactions. One of these gatekeepers was Arthur Andersen, Enron's auditor. Andersen had a duty to warn Enron's Board of Directors about "significant unusual transactions," including "off-balance-sheet financing, and accounting for equity investments."<sup>58</sup> According to Neal Batson, the court-appointed

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46. *Id.* at 86.

47. *Id.*

48. ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON 230 (2002).

49. *See id.*

50. *Id.* at 311–12.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.* at 310–12.

57. Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 163 (2002).

58. NEAL BATSON, IN RE: ENRON CORP., *ET AL.*, DEBTORS, CH. 11, FINAL REPORT 24 (Case No. 01-16034 (AJG)) (Bankr. S.D.N.Y., 2003), [http://www.concernedshareholders.com/CCS\\_ENRON\\_Report.pdf](http://www.concernedshareholders.com/CCS_ENRON_Report.pdf) [<https://perma.cc/852M-EEMZ>].

examiner for Enron's bankruptcy, Andersen accountants knew about the conflict of interest created by the LJM1/Rhythms transaction, but failed to warn the Board about their concerns over the agreement.<sup>59</sup>

Andersen's failure was unexpected because the accounting giant apparently had little incentive to risk its reputation. At the time of Enron's collapse, Andersen had 2300 clients.<sup>60</sup> While Andersen did anticipate earning \$100 million in fees from Enron, this amount was a fraction of the \$9 billion in annual revenue for the accounting firm.<sup>61</sup> In fact, during the 1990s, many courts believed that auditing firms would refrain from acting so irrationally for exactly this reason.<sup>62</sup> In the leading case stating this proposition, *DiLeo v. Ernst & Young*, the Seventh Circuit rejected the claim that an accounting firm had committed securities fraud by helping a failing bank understate poor performing loans by \$4 billion.<sup>63</sup> The court rejected the argument that the accounting firm possessed the mental state of mind necessary for establishing a securities violation.<sup>64</sup> The court reached this conclusion because the partners and associates had nothing to gain from helping the bank commit fraud.<sup>65</sup> The risk to the accountants' reputations far outweighed the financial benefits they would have derived from aiding and abetting the alleged fraud.<sup>66</sup>

Researchers have attributed Andersen's gatekeeping failure to various conflicts of interest. One form of conflict was the combining of auditing and consulting services.<sup>67</sup> Prior to the mid-1990s, few auditing firms participated in consulting activities.<sup>68</sup> However, during the late 1990s, auditing firms engaged in consulting and auditing activities because consulting was so lucrative.<sup>69</sup> In fact, a survey conducted during that period found that corporations paid their auditor for consulting services at three times the amount for auditing services.<sup>70</sup> Andersen's relationship with Enron fit this trend. More than seventy percent of the fees that Andersen received from Enron came from consulting.<sup>71</sup> Thus, participation in consulting activities might have eroded Andersen's independence because the company was loath to lose its consulting fees.<sup>72</sup>

59. *Id.* at 44–45.

60. John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1406 (2002).

61. *Id.*

62. *Id.*

63. 901 F.2d 624 (7th Cir. 1990).

64. *Id.* at 627–28.

65. *Id.* at 629.

66. *Id.*

67. John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 291–93 (2004).

68. *Id.* at 291.

69. Justin Cummins & Meg Luger Nikolai, *ERISA Reform in a Post-Enron World*, 39 J. MARSHALL L. REV. 563, 587 (2006).

70. Coffee, *supra* note 67, at 291.

71. See Gary M. Cunningham & Jean E. Harris, *Enron and Arthur Andersen: The Case of the Crooked E and the Fallen A*, 3 GLOBAL PERSP. ACC'T EDUC. 27, 43 (2006).

72. See Coffee, *supra* note 67, at 293.

Another form of conflict came in the intertwined relationships between the staffs of Andersen and Enron.<sup>73</sup> David Duncan, Andersen's chief auditor of the Enron account, was a close friend of Richard Causey, Enron's chief accounting officer.<sup>74</sup> In fact, the relationship between the two was so close that Enron employees had a difficult time determining who was working for Enron and who was working for Andersen.<sup>75</sup>

Researchers have also asserted that the deterrents in place to guard against auditor fraud were insufficient.<sup>76</sup> One such deterrent was the Public Oversight Board (POB), which the accounting profession created in 1977 in an attempt at self-regulation.<sup>77</sup> This peer review system proved to be ineffective, however. Prior to its disbanding in 2002, no firm received a negative review.<sup>78</sup> Critics even characterized the POB's peer-review program as "incestuous" and a "backslapping exercise."<sup>79</sup> In the 1990s, both the Supreme Court and Congress weakened the effectiveness of yet another deterrent, shareholder lawsuits: In 1994, the Supreme Court ruled in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* that private parties may not bring private causes of action against gatekeepers under § 10(b) of the Securities and Exchange Act for aiding and abetting fraud.<sup>80</sup> One year later, Congress enacted the Private Securities Litigation Reform Act (PSLRA). The PSLRA imposed stricter securities fraud pleading requirements and eliminated the ability of plaintiffs to obtain treble damages through civil Racketeering Influenced and Corrupt Organizations Act (RICO) challenges.<sup>81</sup>

### B. Independent Analysts

Independent analysts also failed to protect shareholders from Enron's duplicity. Independent analysts collect and process information about the companies they follow. Based on this information, analysts issue reports advising their clients about a company's prospects.<sup>82</sup> The analysts tracking Enron failed at this task. For instance, in October 2001, all sixteen analysts followed by Thomson Financial/First Call rated Enron as a "buy," despite the fact that Enron stock had fallen fifty percent.<sup>83</sup> Further in November 2001—after the SEC had announced that it was investigating Enron—

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73. Jennings, *supra* note 13, at 164.

74. *Id.* at 170 n.23.

75. Marianne M. Jennings, *Restoring Ethical Gumption in the Corporation: A Federalist Paper on Corporate Governance – Restoration of Active Virtue in the Corporate Structure To Curb the "Yeeshaw Culture" in Organizations*, 3 WYO. L. REV. 387, 408 (2003).

76. Kroger, *supra* note 2, at 91.

77. Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 472–73 (2002).

78. *Id.* at 473.

79. *Id.* at 472; Kroger, *supra* note 2, at 91 n.166.

80. 511 U.S. 164, 191 (1994).

81. Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

82. Millon, *supra* note 14, at 313.

83. Macey, *supra* note 13, at 403–04.

eleven of the thirteen analysts following Enron still rated the company as a “buy.”<sup>84</sup> This poor showing by the analysts was not surprising. The investment banks that hire the analysts want positive ratings for companies, which raise stock prices and in turn produce capital for their investment clients.<sup>85</sup>

### C. Credit Rating Agencies

Credit rating agencies are independent entities that assess an institution’s ability to pay its financial obligations.<sup>86</sup> The two major credit rating agencies—Standard & Poor’s and Moody’s—also failed to fulfill their gatekeeping role. These entities did not downgrade Enron’s debt below investment grade until four days before the firm declared bankruptcy.<sup>87</sup> The credit rating agencies probably failed to perform their corporate governance role because downgrades frequently lead to bankruptcy.<sup>88</sup> Ironically, this reluctance to downgrade Enron had the unintended effect of undermining the agencies’ ability to serve as effective monitors.<sup>89</sup>

### D. Enron’s Board of Directors

A corporation’s board of directors has a fiduciary duty to its investors to monitor management performance.<sup>90</sup> With respect to the LJM transactions, the Enron board failed in its gatekeeping role in two ways.<sup>91</sup> First, the board should not have waived its code of ethics, which prohibited Enron’s employees from occupying positions that conflicted with their fiduciary duties to the company, to permit Fastow to manage the SPEs. Because Fastow was Enron’s CFO, the conflict of interest was too severe.<sup>92</sup> Second, the board failed to ensure that no one profited from the LJM transactions at the expense of Enron’s shareholders.<sup>93</sup> Notably, it never asked Fastow how much money he was making from the LJM agreements.<sup>94</sup> This lapse was critical because it was later revealed that Fastow illegally accrued \$30 million from the deals.<sup>95</sup>

There are several reasons for the board’s failure to provide sufficient oversight over Enron’s SPE transactions. For instance, Enron was a Fortune 500 company with thousands of employees, complex financing, and many product and service lines. Boards of directors do not have much time to commit to the difficult task of providing oversight. And these directors were certainly not as devoted to supervising Enron’s

84. *Id.*

85. *Id.*

86. SEC. EXCH. COMM’N, OFFICE INV. EDUC. & ADVOCACY, INVESTOR BULLETIN: THE ABC’S OF CREDIT RATINGS 1 (2013), [https://www.sec.gov/investor/alerts/ib\\_creditratings.pdf](https://www.sec.gov/investor/alerts/ib_creditratings.pdf) [<https://perma.cc/5BKA-5DW2>].

87. Macey, *supra* note 13, at 405.

88. *Id.* at 406.

89. *Id.*

90. Kroger, *supra* note 2, at 94.

91. *Id.* at 95.

92. *Id.*

93. *Id.* at 96.

94. *Id.*

95. *Id.*

performance as the company's management.<sup>96</sup> Also, boards of directors have little at stake in the direction that a company might go. The performance of a corporation does not seriously impact their reputations, and board members usually "have insurance to indemnify them [from] any liability stemming from their actions."<sup>97</sup>

#### *E. Securities and Exchange Commission (SEC)*

The SEC is the federal governmental agency tasked with the responsibility of preventing securities fraud and protecting investors. Because the SEC had the same information as independent analysts, the agency should have found Enron's confusing financial statements and "disturbingly opaque" disclosures of its SPEs alarming.<sup>98</sup> Yet, the SEC failed to mount an investigation until after the company was doomed. In fact, the SEC did not review any of Enron's quarterly (10-Q) or annual (10-K) findings from 1998 to 2001.<sup>99</sup> If the SEC's attorneys and accountants had reviewed Enron's financial statements during this period, they would have probably identified major problems that warranted further examination.<sup>100</sup>

The agency's leadership claimed that it did not have the resources to investigate Enron because the number of publicly owned companies dramatically increased in the 1990s at a much faster rate than the SEC's capacity to provide oversight.<sup>101</sup> Consequently, the SEC asserted that it focused its limited resources on reviewing public offerings instead of corporate giants like Enron. John Kroger, who worked as a trial attorney with the United States Department of Justice's Enron Task Force, rejects this assertion. Because "Fortune 500 companies play a critical role in the American securities market," Kroger claimed the SEC had "a particular duty to ensure that these behemoths are playing by the rules."<sup>102</sup> Instead, Kroger attributed the SEC's failure to poor management and poor prioritizing.<sup>103</sup> In support of his assertion, Kroger cited a post-Enron study of SEC management practices, which found that supervisors assigned numerical goals that employees reviewing filings had to satisfy.<sup>104</sup> Because of these incentives, it was not surprising that SEC staff failed to examine Enron's complicated SEC filings.<sup>105</sup>

### III: CHARTER SCHOOLS AND RELATED-PARTY TRANSACTIONS

#### *A. Charter School Deregulation and Private Investors*

Some individuals and corporations in the charter school sector have used Enron-like related-party transactions to obtain profits at the expense of the very charter

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96. *Id.* at 97–98.

97. *Id.* at 98.

98. *Id.* at 107.

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.* at 108.

103. *Id.*

104. *Id.*

105. *Id.*

schools that they are serving. Charter schools are often distinguished from traditional public schools on the ground that they have greater accountability in exchange for greater autonomy.<sup>106</sup> Accountability comes in the form of the charter, a contract that defines the educational goals that the charter school must attain.<sup>107</sup> Autonomy comes in the form of deregulation, which frequently involves exemption from state laws that govern budgets and financial transparency.<sup>108</sup>

Forty-three states and the District of Columbia have charter school legislation.<sup>109</sup> There are more than 6800 charter schools in the nation serving 2.9 million students.<sup>110</sup> Charter schools, which presently make up six percent of public school enrollment, have experienced substantial growth since their inception. In fact, enrollment in charter schools has increased six-fold in the last fifteen years.<sup>111</sup>

Major philanthropic organizations have invested heavily in the charter school sector.<sup>112</sup> For example, the Walton Family Foundation, which was established by the founder of the Walmart retail chain, has pledged \$1 billion to support charter schools.<sup>113</sup> Reed Hastings, the founder of Netflix and a long-time supporter of charter schools, has created a \$100 million education foundation.<sup>114</sup> Hedge funds and other private investors have also become interested in investing in charter schools.<sup>115</sup>

The attention of philanthropic groups and private investors has dramatically impacted the charter school sector. For example, the education management organizations (EMOs) that these groups operate have become the dominant players in the

106. See, e.g., *Frequently Asked Questions About Public, Charter Schools*, UNCOMMON SCHOOLS, <http://www.uncommonschools.org/faq-what-is-charter-school> [https://perma.cc/2PJR-FG2M]; *About Charter Schools*, NAT'L ALLIANCE PUB. CHARTER SCHOOLS, <http://www.publiccharters.org/get-the-facts/public-charter-schools/> [https://perma.cc/BRQ7-74JM].

107. *Frequently Asked Questions About Public, Charter Schools*, *supra* note 106.

108. *Id.*

109. JENNIFER THOMSEN, EDUC. COMM'N OF THE STATES, 50-STATE COMPARISON: CHARTER SCHOOL POLICIES (2017), <http://www.ecs.org/charter-school-policies/> [https://perma.cc/TR4Y-H7YU].

110. NAT'L ALL. PUB. CHARTER SCHS., A CLOSER LOOK AT THE CHARTER SCHOOL MOVEMENT 1 (2016), <http://www.publiccharters.org/wp-content/uploads/2016/02/New-Closed-2016.pdf> [https://perma.cc/Z3ER-854A].

111. *Id.*

112. Noelle Quam, Note, *Big Philanthropy's Unrestrained Influence: A Call for Change*, 21 WASH. & LEE J. C.R. & SOC. JUST. 601, 620 (2015).

113. Abby Jackson, *The Walmart Family Has Pledged \$1 Billion To Help a Polarizing Kind of School*, BUS. INSIDER (Jan. 19, 2016, 3:24 P.M.), <http://www.businessinsider.com/walmart-family-pledged-1-billion-to-charter-schools-2016-1> [https://perma.cc/QXQ9-L8XK].

114. Emma Brown, *Netflix Chief Announces \$100 Million for Education*, WASH. POST (Jan. 13, 2016), <https://www.washingtonpost.com/news/education/wp/2016/01/13/netflix-chief-announces-100-million-fund-for-education> [https://perma.cc/8M84-C97J].

115. See, e.g., Stephen Vita, *Inside the Hedge Fund Infatuation with Charter Schools*, INVESTOPEDIA (Mar. 9, 2016, 4:04 AM), <http://www.investopedia.com/articles/investing/030916/inside-hedge-fund-infatuation-charter-schools.asp> [https://perma.cc/F3UH-LM73]; *Power Players: Pennsylvania's Top Political Donors, 2011-2012*, PUB. SOURCE, <http://powerplayers-pa.herokuapp.com/donors/vahan-gureghian-i> [https://perma.cc/6MBP-MJS6] (describing the political contributions of the CEO of Charter School Management Inc.).

charter school sector.<sup>116</sup> EMOs are for-profit or nonprofit entities that provide educational and management services to charter schools.<sup>117</sup> EMOs manage between thirty-five to forty percent of all charter schools, accounting for about forty-five percent of charter school enrollments.<sup>118</sup>

Charter schools attract investors because of the potential for new revenue streams.<sup>119</sup> For instance, the New Market Tax Credits (NMTC) program provides investors the opportunity to make profits from charter-school real estate transactions.<sup>120</sup> Enacted as a component of the Community Relief Tax Credit Act of 2000,<sup>121</sup> the NMTC was designed to encourage investment in low-income communities.<sup>122</sup> The NMTC accomplishes this goal by providing investors in a community development entity (CDE) a thirty-nine percent tax credit over a seven-year period.<sup>123</sup> A CDE is a corporation or partnership that provides capital for investment in low-income communities.<sup>124</sup> An educational organization such as a charter school foundation can use NMTC funding to build a charter school.<sup>125</sup>

For-profit entities can double their investment in charter-school real estate projects by taking advantage of the NMTC as well as other federal tax credits.<sup>126</sup> For-profit entities can also obtain revenue from charter schools through lease payments for the use of the facilities. For instance, the Robert Bacon Academy (RBA), a for-profit EMO operating in North Carolina, received \$1.5 million in rent, as well as

116. BRUCE BAKER & GARY MIRON, *THE BUSINESS OF CHARTER SCHOOLING: UNDERSTANDING THE POLICIES THAT CHARTER OPERATORS USE FOR FINANCIAL BENEFIT 7* (2015), [http://nepc.colorado.edu/files/rb\\_baker-miron\\_charter\\_revenue\\_0.pdf](http://nepc.colorado.edu/files/rb_baker-miron_charter_revenue_0.pdf) [https://perma.cc/ZA4F-69CE].

117. *Id.* Charter school advocates often distinguish for-profit EMOs from nonprofit charter management organizations (CMOs). Apparently, they make this distinction to counter criticisms of fraud and mismanagement in the charter school sector. *See, e.g.*, Arianna Prothero, *Audit: How Charter School Management Groups Pose Risks to Federal Funds*, EDUC. WK.: CHARTERS & CHOICE (Oct. 4, 2016, 4:15 PM), [http://blogs.edweek.org/edweek/charterschoice/2016/10/audit\\_charter\\_school\\_management\\_groups\\_pose\\_risk\\_t\\_federal\\_funds.html](http://blogs.edweek.org/edweek/charterschoice/2016/10/audit_charter_school_management_groups_pose_risk_t_federal_funds.html) [https://perma.cc/63GT-TZ8N]. However, in Imagine Schools' real estate dealshow, even the CEO of a nonprofit management organization can engage in related-party transactions with for-profit entities that work against the interests of the charter schools served by the nonprofit management organization. *See infra* notes 127–44.

118. BAKER & MIRON, *supra* note 116, at 7.

119. Elaine Magliaro, *Charter Schools and the Profit Motive*, JONATHAN TURLEY (Mar. 16, 2013), <https://jonathanturley.org/2013/03/16/charter-schools-and-the-profit-motive/> [https://perma.cc/VM2R-XKPJ].

120. 26 U.S.C.A. § 45D (2011 & West Supp. 2017).

121. Pub. L. No. 106-554, § 121, 114 Stat. 2763A-605 (2000).

122. Michael I. Sanders, *How Nonprofit Organizations Can Use the New Markets Tax Credit*, 21 TAX'N EXEMPTS 3, 3 (Nov./Dec. 2009).

123. *Id.*

124. *Id.*

125. *Id.* at 8. Juan Gonzalez, *Albany Charter Cash Cow: Big Banks Making a Bundle on New School Construction as Schools Bear the Cost*, N.Y. DAILY NEWS (May 6, 2010, 8:48 P.M.), <http://www.nydailynews.com/new-york/education/albany-charter-cash-big-banks-making-bundle-new-construction-schools-bear-cost-article-1.448008> [https://perma.cc/PBM5-A55Y].

126. Gonzalez, *supra* note 125.

almost \$549,000 for maintenance during the 2013–14 school year—from one charter school alone.<sup>127</sup>

Investors can also obtain profits through the management fees that EMOs charge for their services.<sup>128</sup> Management fees can be very generous. In the 2013–14 school year, RBA received a management fee of sixteen percent of its school’s expense as well as “additional incentive payments based on student achievement.”<sup>129</sup> Two charter schools paid RBA nearly “\$2.4 million in fees and incentives out of just \$13 million in total revenue.”<sup>130</sup>

### *B. Examples of Enron-Like Related-Party Transactions*

#### 1. Imagine Schools

Imagine Schools’ real estate deals provide an example of the ways that charter school investors are engaging in Enron-like related-party transactions. Founded by Dennis Bakke and his wife, Imagine Schools is a nonprofit EMO that operates sixty-three charter school campuses enrolling more than 33,000 students in eleven states and the District of Columbia.<sup>131</sup> Imagine Schools uses real estate investment trusts (REITs) and triple-net leases for its real estate deals.<sup>132</sup> A REIT is a company “that owns and manages . . . propert[y] . . . and is required to distribute ninety percent of [its] income to investors.”<sup>133</sup> A REIT is similar to a mutual fund because it enables shareholders to obtain a steady income stream.<sup>134</sup> A triple-net lease is a lease agreement whereby the lessee is responsible for rent fees as well as related costs, including taxes, insurance, and facilities maintenance.<sup>135</sup> Thus, triple-net leases can be especially costly for charter schools and put a great deal of stress on annual operating expenses.<sup>136</sup>

Imagine Schools conducts many of its real estate deals through its for-profit subsidiary, SchoolHouse Finance (SchoolHouse).<sup>137</sup> In a typical deal, a charter school

127. Thomas A. Kelly III, *North Carolina Charter Schools’ (Non-?) Compliance with State and Federal Nonprofit Law*, 93 N.C. L. REV. 1757, 1794 (2015).

128. Robert Cotto Jr., *Show Me the (Charter Management Fee) Money!*, CT NEWS JUNKIE (May 20, 2015, 7:59 AM), [http://www.ctnewsjunkie.com/archives/entry/op-ed\\_show\\_me\\_the\\_charter\\_management\\_fee\\_money/](http://www.ctnewsjunkie.com/archives/entry/op-ed_show_me_the_charter_management_fee_money/) [<https://perma.cc/5X3A-LFJC>].

129. Kelly, *supra* note 127, at 1793.

130. *Id.* at 1793–94.

131. *Imagine Schools Completes Transition to Non-Profit Status*, IMAGINE SCHOOLS., (Aug. 18, 2015), <http://www.imagineschools.org/2015/08/imagine-schools-completes-transition-to-non-profit-status> [<https://perma.cc/57ZQ-EDL5>].

132. PIET VAN LIER, POLICY MATTERS OHIO, PUBLIC GOOD VS. PRIVATE PROFIT: IMAGINE SCHOOLS, INC. IN OHIO 3 (2010), <http://www.policymattersohio.org/wp-content/uploads/2011/09/ImagineSchools2010.pdf> [<https://perma.cc/ZPY9-AL8S>].

133. *Id.*

134. *Id.*

135. Bill Stoller, *Morgan Stanley’s Top 5 REIT Picks for Q4*, BEZINGA (Oct. 1, 2014, 12:21 PM), <http://www.benzinga.com/analyst-ratings/analyst-color/14/10/4888872/morgan-stanleys-top-5-reit-picks-for-q4> [<https://perma.cc/25YX-WP98>].

136. BAKER & MIRON, *supra* note 116, at 33.

137. NONPROFIT CHARTER SCHOOLS HIDE FOR-PROFIT REAL ESTATE DEALS, FOR-PROFIT

operated by Imagine Schools leases the building from SchoolHouse. In turn, SchoolHouse sells the property to Entertainment Properties (EPR) Trust, a REIT that has partnered with Imagine Schools and SchoolHouse.<sup>138</sup> EPR Trust then leases the property to SchoolHouse at a lower rate than the lease paid by the charter school.<sup>139</sup>

The rent of charter schools operated by Imagine Schools can be exorbitant. Many charter schools spend around fourteen percent of their public funding on building rent.<sup>140</sup> By contrast, charter schools run by Imagine Schools spend up to an excessive forty percent of their public funding on rent, creating a tight budget for educational necessities, such as textbooks.<sup>141</sup> Thus, these triple-net leases can be even more costly to the charter schools in the long run than direct mortgages.<sup>142</sup>

In *Renaissance Academy for Math & Science of Missouri v. Imagine Schools*, a federal district court ruled that the EMO committed a breach of fiduciary duty by causing a charter school governing board to enter into unreasonable lease agreements with SchoolHouse.<sup>143</sup> According to the court, these leases “clearly constituted self-dealing.”<sup>144</sup> Because Imagine Schools was the sole owner of SchoolHouse, the EMO also benefited from the excessive leases.<sup>145</sup>

As a fiduciary, Imagine Schools had a duty to the charter school to refrain from self-dealing.<sup>146</sup> The EMO could act as an adverse party to the charter school only if it had obtained informed consent from the charter school governing board.<sup>147</sup> The court found no evidence that Imagine Schools had informed the board how it would benefit from the leases, or that their high cost “would result in lower-than-average instructional expenditures, including textbooks, classroom supplies, and teacher salaries, which was exactly what happened.”<sup>148</sup> The court ordered Imagine Schools to pay \$935,400 in damages for the breach of fiduciary duty.<sup>149</sup>

## 2. Ivy Academia Charter School

Yevgeny Selivanov, the founder and CEO of Ivy Academia Charter School, located near Los Angeles, also engaged in related-party transactions that worked against the best interests of the charter schools that he operated. Ivy Academia Charter School is a K–12 school that educates almost 1000 students.<sup>150</sup> In April 2013,

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EDUC. (2012), <http://ic.galegroup.com/ic/ovic/ViewpointsDetailsPage/DocumentToolsPortletWindow?displayGroupName=Viewpoints&jsid=debf351f8b49a01edd183ae07060240&action=2&catId=&documentId=GALE%7CEJ3010774219&u=magn0126&zid=1116959505bea971f514b6b84cf25fa6> [https://perma.cc/BUY5-5U6U].

138. VAN LIER, *supra* note 132, at 24–25.

139. NONPROFIT CHARTER SCHOOLS, *supra* note 137.

140. *Id.*

141. *Id.*

142. VAN LIER, *supra* note 132, at 28.

143. No. 4:13-CV-00645-NKL, 2014 WL 7267033, at \*10 (W.D. Mo. Dec. 18, 2014).

144. *Id.* at 17.

145. *Id.*

146. *Id.* at 18.

147. *Id.*

148. *Id.* at 18–19.

149. *Id.* at 24–25.

150. U.S. NEWS, IVY ACADEMIA, <http://www.usnews.com/education/best-high-schools>

a California jury convicted Selivanov and his wife and co-founder, Tatyana Berkovich, of felonies and misdemeanors related to their actions as founders of the Ivy Academia Charter School.<sup>151</sup> Later that year, the trial court sentenced Selivanov to nearly five years in state prison.<sup>152</sup> Berkovich was sentenced to forty-five days in county jail, 320 hours of service to the community and five years of probation.<sup>153</sup> The court imposed a harsher sentence on Selivanov because he was the main architect of the “sophisticated” scam.<sup>154</sup> Selivanov, who had an MBA, had previously worked at Goldman Sachs,<sup>155</sup> which describes itself as “a leading global investment banking, securities, and investment managing firm.”<sup>156</sup>

Selivanov and Berkovich were also co-owners of a private preschool, Academy Just for Kids (AJFK), which shared a campus with the charter school.<sup>157</sup> In 2004, AJFK entered into a sublease for that campus at a monthly rent of \$18,390.<sup>158</sup> AJFK then assigned the sublease to Alternative, the parent company of Ivy Academia Charter School. Alternative assumed responsibility for the monthly rent payments.<sup>159</sup>

In 2007, AJFK and Alternative entered into another agreement, which increased the monthly rent from \$18,370 to \$43,870, even though: (1) the lower amount was the fair market value, (2) the lower rent was valid until 2014, and (3) the original lease prohibited rents from being increased by more than five percent annually.<sup>160</sup> Selivanov and Berkovich did not present the rent increase to Alternative’s board until October 2008.<sup>161</sup> The board not only approved the rent increase, but it also made the rate effective as of July 1, 2007.<sup>162</sup> As a result, Alternative paid a net rent increase of nearly \$238,000.<sup>163</sup> At trial, an expert characterized the rent increase as a “sham transaction” because there was no sound basis for the increased payment.<sup>164</sup>

At the same time of the rent increase, Selivanov and Berkovich secured a bank loan of \$520,000 for the remodeling of the facility housing the charter school.<sup>165</sup> AJFK and Ivy Academia Charter School then entered into an asset sale for the remodeling of the property. Ivy Academia Charter School transferred the leasehold

/california/districts/los-angeles-unified-school-district/ivy-academia-91570 [https://perma.cc/5JNJ-CBMN].

151. Kelly Goff, *Ivy Academia Founders Sentenced in Fraud Case*, L.A. DAILY NEWS (Oct. 4, 2013, 12:00 AM), <http://www.dailynews.com/general-news/20131004/ivy-academia-founders-sentenced-in-fraud-case> [https://perma.cc/3ATY-DDBN].

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. GOLDMAN SACHS, WHO WE ARE, <http://www.goldmansachs.com/who-we-are/at-a-glance/index.html> [https://perma.cc/HEF7-AW8H].

157. Brief for Respondent at 3, *People. v. Selivanov*, 210 Cal. Rptr. 3d 117 (Cal. Ct. App. 2016) (No. B252894).

158. *Id.* at 6.

159. *Id.* at 11.

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.* at 12.

164. *Id.*

165. *Id.* at 13.

improvements to AJFK. In exchange for this transfer, AJFK assumed and made payments on the bank loan.<sup>166</sup> These loan payments were characterized as rent payments.<sup>167</sup> However, the asset sale was invalid because the original lease provided that assets were to remain with the property. Thus, AJFK should have been making the payments on the asset sale.<sup>168</sup> Also, Ivy Academia Charter School's payments for the bank loan should not have been characterized as rent payments because the rent increase and asset sales were separate transactions.<sup>169</sup> At trial, a forensic accountant testified that Ivy Academia Charter School's payment of the loan and the accounting method of recording the rent payment as a lease were inappropriate.<sup>170</sup>

### 3. American Indian Model Charter Schools

Ben Chavis, the former superintendent of the American Indian Model Charter Schools (AIMS), and his wife used inappropriate related-party transactions to funnel public funds and illegal payments from parents into the businesses they ran. The AIMS are a system of two middle schools and a high school that are located in the Oakland area, educating a total of more than 1100 students.<sup>171</sup> In December 2011, California's Fiscal Crisis Assistance and Management Team (FCMAT) received a request from the local county board of education to conduct an extraordinary audit of the schools after it had received multiple allegations of inappropriate related-party transactions.<sup>172</sup> FCMAT is a state agency that helps local school districts satisfy their financial and management responsibilities.<sup>173</sup> One month after FCMAT agreed to do the audit, Chavis resigned from his position as superintendent.<sup>174</sup>

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166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.* at 14.

171. American Indian Public Charter School II is a K–8 school that educates 650 students. Am. Indian Model Schs., *Home*, AIPSC II 171 12<sup>TH</sup> STREET OAKLAND, CA, [http://www.aimschools.org/apps/pages/index.jsp?uREC\\_ID=365094&type=d&pREC\\_ID=811338](http://www.aimschools.org/apps/pages/index.jsp?uREC_ID=365094&type=d&pREC_ID=811338) [<https://perma.cc/U2KC-LDZG>]. American Indian Public Charter School educates 250 students from grades 6–8. Am. Indian Model Schs., *Home*, AIPSC 171 12<sup>TH</sup> STREET OAKLAND, CA, [http://www.aimschools.org/apps/pages/index.jsp?uREC\\_ID=365093&type=d&pREC\\_ID=811337](http://www.aimschools.org/apps/pages/index.jsp?uREC_ID=365093&type=d&pREC_ID=811337) [<https://perma.cc/7FVQ-AG8X>]. American Indian Public High School has an enrollment of 350 students. Am. Indian Model Schs., *Home*, AIPHS 746 GRAND AVENUE OAKLAND, CA, [http://www.aimschools.org/apps/pages/index.jsp?uREC\\_ID=365095&type=d&pREC\\_ID=811339](http://www.aimschools.org/apps/pages/index.jsp?uREC_ID=365095&type=d&pREC_ID=811339) [<https://perma.cc/T5JZ-WHQW>].

172. FISCAL CRISIS & MGMT. ASSISTANCE TEAM, ALAMEDA COUNTY OFFICE OF EDUCATION: EXTRAORDINARY AUDIT OF THE AMERICAN INDIAN MODEL CHARTER SCHOOLS 1 (2012), <http://fcmat.org/wp-content/uploads/sites/4/2014/02/AlamedaCOEfinalreport6121292.pdf> [<https://perma.cc/FZB2-X8N2>].

173. FISCAL CRISIS & MGMT. ASSISTANCE TEAM, *FCMAT's Function*, <http://fcmat.org/fcmats-function/> [<https://perma.cc/8QFQ-NKYV>].

174. lumbeelovechild, *AICPS Board Meeting Conflict of Interest Concerns*, YOUTUBE (Jan. 15, 2012), <https://www.youtube.com/watch?v=qFHzGKVit3o> [<https://perma.cc/QGP4-8WLQ>].

In June 2012, FCMAT published the results of its audit. The agency found that from 2007 to 2011, Chavis and his wife had received almost \$3.8 million in payments from school accounts.<sup>175</sup> Many of these payments were linked to related-party transactions that were, indeed, in violation of the state's conflict of interest laws.<sup>176</sup> One transaction involved the Stanford Academic Institute of Learning Summer Mathematics Initiative (SAIL), a privately operated summer program owned by Chavis and a former board member.<sup>177</sup> SAIL charged the charter schools \$500 per student. From the 2009–10 fiscal year through 2011, the charter schools paid SAIL \$355,000.<sup>178</sup> FCMAT found that these students were required to attend SAIL, which was in violation of state law.<sup>179</sup> Additionally, students were fined fifty dollars per day for each day that they missed. According to FCMAT, this charge was also a violation of state law.<sup>180</sup>

The construction projects between the AIMS and companies owned by Chavis constituted another form of illegal related-party transactions. FCMAT found that AIMS schools paid Chavis's companies more than \$1.5 million for construction improvements.<sup>181</sup> Many of these transactions occurred without formal contracts, competitive bidding, or authorization from the charter schools' governing board.<sup>182</sup>

#### 4. Grand Traverse Academy

Steven Ingersoll, the founder of Michigan's Grand Traverse Academy (GTA) also used a related-party transaction scheme to enrich his coffers. GTA enrolls nearly 1300 students from pre-K to twelfth grade.<sup>183</sup> At the start of every school year, GTA prepaid a management fee to Ingersoll's EMO, Smart Schools Management.<sup>184</sup> Because of concerns with GTA's prepayment practices, the charter school's authorizer requested that a new auditor review the charter school's books.<sup>185</sup> In 2013, the new auditor found that the charter school had advanced Ingersoll's management company more than \$2.3 million in management fees.<sup>186</sup> That same year, an attorney for GTA sent Ingersoll a demand letter claiming that he owed \$3.5 million

175. FISCAL CRISIS & MGMT. ASSISTANCE TEAM, *supra* note 172.

176. *Id.* at 11–28.

177. *Id.* at 15.

178. *Id.* at 16.

179. *Id.*

180. *Id.*

181. *Id.* at 24–26.

182. *Id.* at 25.

183. GRAND TRAVERSE ACAD., *School Profile*, ABOUT US, <https://www.mygta.us/school-profile-1> [<https://perma.cc/4UX6-UVQV>].

184. Jennifer Dixon, *Charter Founder Facing Trial on Bank Fraud Charges*, DET. FREE PRESS (Feb. 7, 2015, 11:03 PM), <http://www.freep.com/story/news/local/michigan/2015/02/07/charter-schools-steven-ingersoll-grand-traverse-academy/23054725/> [<https://perma.cc/K2L2-W9Q8>].

185. *Id.*

186. DENNIS, GARTLAND & NIEGARTH, GRAND TRAVERSE ACADEMY: FINANCIAL STATEMENTS AND REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS 21 (2013), <http://bridgemi.com/wp-content/uploads/2015/01/pdf1.pdf> [<https://perma.cc/WC85-4UNN>].

to the school.<sup>187</sup> Ingersoll tried to repay the debt, but when he fell short by \$1.6 million, the board forgave the remaining debt.<sup>188</sup>

Ingersoll sought to repay GTA by taking out a \$1.8 million line of credit that he received from a local bank. Ingersoll claimed that he was using that money to convert a church to house another charter school that he had founded.<sup>189</sup> However, he diverted \$934,000 of this line of credit into his personal bank account, using some of that money to repay the debt that he owed GTA.<sup>190</sup> In 2015, Ingersoll was convicted of federal tax evasion charges in relation to the church renovation scheme.<sup>191</sup> In 2016, he was sentenced to forty-one months in prison.<sup>192</sup>

### 5. Pennsylvania Cyber Charter School

The scandal involving Pennsylvania Cyber Charter School (“PA Cyber”) shows that unscrupulous related-party transactions can also occur in the virtual school setting. Virtual schools “deliver all curriculum and instruction via the Internet and electronic communication, usually with students at home and teachers at a remote location, and usually with everyone participating at different times.”<sup>193</sup> Nicholas Trombetta was the founder and former CEO of PA Cyber, which at its peak enrolled more than 11,000 students from across the state.<sup>194</sup>

Trombetta also founded other companies that conducted business with PA Cyber. One such entity was the National Network of Digital Schools (NNDS), an EMO that provided curriculum and management services to the charter school.<sup>195</sup>

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187. Chastity Pratt Dawsey, *Upcoming Fraud Trial for Charter School Operator Hangs over Charter School Industry*, MLIVE (Jan 8, 2015, 5:30 AM), [http://www.mlive.com/education/index.ssf/2015/01/upcoming\\_fraud\\_trial\\_for\\_schoo.html](http://www.mlive.com/education/index.ssf/2015/01/upcoming_fraud_trial_for_schoo.html) [<https://perma.cc/ND4R-66HS>].

188. *Id.*

189. *Id.*

190. *Id.*

191. Cole Waterman, *Federal Jury Convicts Bay City Academy Founder Steven Ingersoll of 3 of 6 Tax Fraud Charges*, MLIVE (Mar. 20, 2015, 1:35 PM), [http://www.mlive.com/news/bay-city/index.ssf/2015/03/federal\\_jury\\_convicts\\_bay\\_city.html](http://www.mlive.com/news/bay-city/index.ssf/2015/03/federal_jury_convicts_bay_city.html) [<https://perma.cc/344J-8XZJ>].

192. Cole Waterman, *Bay City Academy Founder Steven Ingersoll Gets 41 Months in Federal Prison*, MLIVE (Dec. 16, 2016, 8:29 AM), [http://www.mlive.com/news/bay-city/index.ssf/2016/12/bay\\_city\\_academy\\_founder\\_steve\\_1.html](http://www.mlive.com/news/bay-city/index.ssf/2016/12/bay_city_academy_founder_steve_1.html) [<https://perma.cc/ZS6Y-3SR5>].

193. GARY MIRON, BRIAN HORVITZ & CHARISSE GULOSINO, NAT’L EDUC. POLICY CTR., *VIRTUAL SCHOOLS IN THE U.S. 2013: POLITICS, PERFORMANCE, POLICY, AND RESEARCH EVIDENCE 1* (2013), <http://nepc.colorado.edu/files/nepc-virtual-2013-section-1-2.pdf> [<https://perma.cc/F3N7-R4PK>]; see also Joseph O. Oluwole & Preston C. Green III, *Virtual Schools, Student Rights, and the First Amendment: Adjusting the Schoolhouse Gate to the 21st Century*, 17 N.C. J.L. & TECH. 221 (2015) (discussing virtual schools).

194. *Trombetta Pleads Guilty*, MORNING J. (Aug. 25, 2016), <http://www.morningjournalnews.com/news/local-news/2016/08/trombetta-pleads-guilty> [<https://perma.cc/4BCP-H387>]. The school presently educates more than 9000 students. *Id.*

195. Albert F. Moran, Comment, *Keeping Them Honest: Proactively Preventing Fraud in Pennsylvania’s Cyber Charter Schools*, 86 TEMP. L. REV. 399, 412 (2014).

An audit of PA Cyber performed by the state auditor general's office revealed that the charter school paid NNDS more than \$153 million from 2011 to 2014, which was almost half of the school's annual expenditures.<sup>196</sup> The auditing office was highly critical of the terms of the management services agreement between the charter school and the EMO. Instead of using a cost-based fee formula, the agreement stipulated that NNDS would receive twelve percent of the charter school's revenues received from the state and enrolling school districts.<sup>197</sup> By not basing payment on actual costs, the state auditor declared that the fee structure weakened the level of accountability demanded of the EMO.<sup>198</sup>

The audit also revealed that the most recent curriculum agreement between PA Cyber and the EMO imposed financial penalties for failure to meet deadlines for the delivery of the curriculum.<sup>199</sup> Yet, when NNDS failed to meet three of four deadlines established in the agreement, PA Cyber's board waived the \$4.2 million in penalties.<sup>200</sup>

In August 2016, Trombetta pleaded guilty to federal tax fraud charges. In his plea, Trombetta admitted that he and others had transferred \$8 million from PA Cyber to other companies controlled by Trombetta, and filed false tax returns to make it seem as though the conspirators received the money, when, in fact, the money went to Trombetta.<sup>201</sup>

### *C. The Federal Government, Related-Party Transactions, and the Need for Strong Gatekeeping*

One might be tempted to conclude that the examples provided in the prior subpart are mere anecdotes, and that there is thus no cause for concern that unreasonable related-party transactions are widespread. However, it is important to keep in mind that two of the EMOs profiled in this subpart alone, Imagine Schools and PA Cyber, educate a combined 42,000 students. Another industry giant, K12 Inc., has been accused of similar transgressions. This for-profit EMO is the largest operator of virtual schools in the country. In 2010–11, K12 Inc. enrolled 65,000 students in forty-eight virtual schools.<sup>202</sup> An exposé of the California Virtual Academies, ten online schools affiliated with K12 Inc.,<sup>203</sup> found that the EMO “effectively controls the schools by providing them with all academic services.”<sup>204</sup> According to accounting experts who

196. PA. DEP'T OF THE AUDITOR GEN., PERFORMANCE AUDIT: PENNSYLVANIA CYBER CHARTER SCHOOL 28 (2016), <http://www.paauditor.gov/Media/Default/Reports/PACyberCharterSchool,%20Beaver,%20092116.pdf> [<https://perma.cc/6FWB-2K3Z>].

197. *Id.* at 29.

198. *Id.*

199. *Id.* at 35.

200. *Id.*

201. *Trombetta Pleads Guilty*, *supra* note 194.

202. GARY MIRON & JESSICA L. URSHEL, NAT'L EDUC. POLICY CTR., UNDERSTANDING AND IMPROVING FULL-TIME VIRTUAL SCHOOLS: A STUDY OF SCHOOL CHARACTERISTICS, SCHOOL FINANCE, AND SCHOOL PERFORMANCE IN SCHOOLS OPERATED BY K12 INC. 2 (2012), <http://nepc.colorado.edu/files/nepc-rb-k12-miron.pdf> [<https://perma.cc/TN5S-DG27>].

203. CAL. VIRTUAL ACADS., WELCOME TO OUR SCHOOL! GRADES K–12, <http://cava.k12.com/> [<https://perma.cc/87E5-VGNV>].

204. Jessica Calefati, *K12 Inc.: California Virtual Academies' Operator Exploits Charter, Charity Laws for Money, Records Show*, MERCURY NEWS (Apr. 17, 2016, 10:48 PM), <http://www.mercurynews.com/2016/04/17/k12-inc-california-virtual-academies-operator->

analyzed the management services agreements, it was “tough to tell where the non-profit ends and where the company begins.”<sup>205</sup>

The management services agreement between K12 Inc. and the California Virtual Academy at San Mateo was especially troubling. The EMO was entitled to as much as seventy-five percent of the charter school’s funding in exchange for its services.<sup>206</sup> The rates for the EMO’s services routinely exceeded what the school could afford—“by more than 25 percent.”<sup>207</sup> While the academy’s application for nonprofit taxation status claimed the agreement between the EMO and the school was the result of “arm’s-length” negotiations, a review of the minutes of the governing board’s meetings revealed that an EMO employee led all of the meetings.<sup>208</sup> Further, the board approved all resolutions promoted by the employee—after an average of only thirteen minutes of deliberation.<sup>209</sup>

In September 2016, the U.S. Department of Education’s Office of the Inspector General (OIG), the agency’s watchdog, published the findings of an audit, which also suggests that inappropriate related-party transactions are common in the charter school sector.<sup>210</sup> This audit, which assessed the risks posed by charter school EMOs to the Department’s objectives, examined thirty-three charter schools from six states: California, Florida, Michigan, New York, Pennsylvania, and Texas.<sup>211</sup> The OIG also reviewed the Department’s monitoring and internal controls.<sup>212</sup> According to the OIG audit, internal controls were essential because they were a “key component in preventing fraud and detecting abuse.”<sup>213</sup>

The OIG detected thirty-six instances of internal control weaknesses, which it divided into three categories: (1) conflicts of interest; (2) insufficient segregation of duties; and (3) related-party transactions.<sup>214</sup> Thirteen of these thirty-six instances involved related-party transactions.<sup>215</sup> According to the OIG, these internal control weaknesses posed considerable risks to the objectives of the Department in three ways. First, these weaknesses increased the possibility of financial waste, fraud,

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exploits-charter-charity-laws-for-money-records-show/ [https://perma.cc/SQJ8-85S9].

205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.*

209. *Id.*

210. OFFICE OF INSPECTOR GEN., U.S. DEP’T OF EDUC., ED-OIG/ A02M0012, NATIONWIDE ASSESSMENT OF CHARTER AND EDUCATION MANAGEMENT ORGANIZATIONS (2016), <https://www2.ed.gov/about/offices/list/oig/auditreports/fy2016/a02m0012.pdf> [https://perma.cc/7424-66DP].

211. *Id.* at 5, 8. The Office of Inspector General referred to both EMOs and charter management organizations (CMOs) as CMOs. The OIG defined a CMO as “any organization that operated or managed one or more charter schools, whether under contract or as charter holders, without regard to the profit motive of the organization.” *Id.* at 1 n.1. EMOs, by contrast, provide “whole school operation” services. *Id.* (internal quotations omitted). For consistency purposes, we use the term EMO to refer to the entities described in the audit.

212. *Id.* at 1.

213. *Id.*

214. *Id.* at 2.

215. *Id.* at 40.

and abuse.<sup>216</sup> Second, by granting fiscal authority to EMOs, charter school governing boards increased the possibility that federal funds would not be used in accordance with federal laws, regulations, and grant requirements.<sup>217</sup> Third, by ceding operational authority to EMOs, charter school governing boards increased the risk that students would not receive services in line with federal program objectives.<sup>218</sup>

In spite of these problems, the federal government has spent more than \$4 billion since 1995 to encourage the growth of charter schools without emphasizing oversight.<sup>219</sup> In fact, one day before the OIG released its highly critical audit, the Department announced that it had awarded \$245 million to support high-quality charter schools through its Charter Schools Program (CSP).<sup>220</sup>

This continual emphasis on charter school growth by the federal government without the attendant oversight might increase the occurrence of illegal related-party transactions. A report co-authored by the Center for Popular Democracy and the Alliance to Reclaim Our Public Schools has claimed to unearth \$200 million in charter school fraud, abuse, and mismanagement in fifteen states.<sup>221</sup> In another report, these two groups claimed that California could lose \$100 million to charter school fraud in 2015.<sup>222</sup> It stands to reason that there will be more transgressions as the number of charter schools increase with insufficient oversight.

Additionally, federal policy might have the unintended effect of harming children in low-income communities—the very students whom expanded choice options are supposed to benefit. Charter schools are frequently portrayed as a way to improve the educational options for students attending schools in low-income and minority neighborhoods.<sup>223</sup> Charter schools have proven to be popular in low-income and minority communities. Indeed, “[m]ore than 80 percent of the students

216. *Id.* at 16.

217. *Id.*

218. *Id.*

219. Dustin Beilke, *New Grants Announced: ED Continues To Pour Millions into Charter School Black Hole*, CTR. FOR MEDIA & DEMOC. PRWATCH (Sept. 29, 2016, 8:13 AM), <http://www.prwatch.org/news/2016/09/13151/education-department-continues-pour-millions-tax-dollars-charter-school-blackhole> [<https://perma.cc/7PLW-F3U2>].

220. U.S. DEP’T OF EDUC., U.S. DEPARTMENT OF EDUCATION AWARDS \$245 MILLION TO SUPPORT HIGH-QUALITY PUBLIC CHARTER SCHOOLS (Sept. 28, 2016), <https://www.ed.gov/news/press-releases/us-department-education-awards-245-million-support-high-quality-public-charter-schools> [<https://perma.cc/BPR2-T7F6>].

221. CTR. FOR POPULAR DEMOCRACY & ALL. TO RECLAIM OUR SCHS., *THE TIP OF THE ICEBERG: CHARTER SCHOOL VULNERABILITIES TO WASTE, FRAUD, AND ABUSE 1* (2015), [https://populardemocracy.org/sites/default/files/Charter-Schools-National-Report\\_rev2.pdf](https://populardemocracy.org/sites/default/files/Charter-Schools-National-Report_rev2.pdf) [<https://perma.cc/5NAN-VD6Z>].

222. CTR. FOR POPULAR DEMOCRACY, ACCE INST. & PUB. ADVOCATES INC., *RISKING PUBLIC MONEY: CALIFORNIA CHARTER SCHOOL FRAUD* (2015), <https://populardemocracy.org/sites/default/files/Charter-Schools-California-Report-b.pdf> [<https://perma.cc/8TEC-ZTVH>].

223. *See, e.g.*, U.S. DEP’T OF EDUC., *ED-01-CO-0012, K-8 CHARTER SCHOOLS: CLOSING THE ACHIEVEMENT GAP* (2007), <https://www2.ed.gov/admins/comm/choice/charterk-8/report.pdf> [<https://perma.cc/FEL3-JZLJ>]; Lew Moore, *Charter Schools Can Benefit Low-Income Students*, HERALDNET (Nov. 15, 2015, 5:03 PM), <http://www.heraldnet.com/opinion/charter-schools-can-benefit-low-income-students> [<https://perma.cc/8GF8-M4SA>];

in the top ten highest-enrollment share districts qualify for free or reduced priced lunch, while 86 percent are from minority backgrounds.”<sup>224</sup> Thus, a federal policy that emphasizes growth without oversight would likely disproportionately impact charter schools in these communities.

In fact, this apprehension, *inter alia*, caused the National Association for the Advancement of Colored People (NAACP) to ratify a resolution “calling for a moratorium on charter school expansion and for the strengthening of oversight” in October 2016.<sup>225</sup> This resolution included several concerns about the impact of fraud and mismanagement that charter schools posed for “low-income areas and communities of color.”<sup>226</sup> Because weak oversight puts “public funds at risk of being wasted,” the NAACP resolved to seek legislation that would “strengthen the investigative powers of those bodies that oversee charter school fraud, corruption, [and] waste.”<sup>227</sup> Moreover, the civil rights organization further resolved to oppose bills that “weaken[ed] the investigative powers of any legislative body from uncovering charter school fraud, corruption, and/or waste.”<sup>228</sup>

Because of the potential dangers posed by related-party transactions, strong gatekeeping is vital. The next part examines the statutory and regulatory provisions that apply to charter school gatekeepers to identify the tools they will need to meet this challenge.

#### IV: CHARTER SCHOOL GATEKEEPERS

##### *A. Auditors*

Auditors serve as gatekeepers in the charter school sector as well as the financial markets. States generally require charter schools to undergo annual financial audits that comply with statutory or regulatory standards.<sup>229</sup> Table 1 identifies the entities that are responsible for performing the annual audit on charter schools.

*Facts on Public Charters*, STAND FOR CHILDREN (2017), <http://stand.org/evidenceoncharterschools> [<https://perma.cc/X5GV-5LFG>]; Matt Vespa, *In Denver, Charter Schools Lead the Way in Helping Low-Income Students*, TOWNHALL (Nov. 30, 2016, 6:30 PM), <http://townhall.com/tipsheet/mattvespa/2016/11/30/in-denver-charter-schools-lead-the-way-in-helping-low-income-students-n2253001> [<https://perma.cc/KN9E-SVX4>].

224. NAT’L ALL. FOR PUB. CHARTER SCH., *A GROWING MOVEMENT: AMERICA’S LARGEST CHARTER SCHOOL COMMUNITIES* (2015), [http://www.publiccharters.org/wp-content/uploads/2015/11/enrollmentsshare\\_web.pdf](http://www.publiccharters.org/wp-content/uploads/2015/11/enrollmentsshare_web.pdf) [<https://perma.cc/MYX3-XW3L>].

225. NAT’L ASS’N FOR ADVANCEMENT OF COLORED PEOPLE, *STATEMENT REGARDING THE NAACP’S RESOLUTION ON A MORATORIUM ON CHARTER SCHOOLS* (2016), <http://www.naacp.org/latest/statement-regarding-naacps-resolution-moratorium-charter-schools> [<https://perma.cc/6KZA-MY8U>].

226. Julian Vasquez Heilig, *Breaking News: @NAACP Calls for National Moratoriums on Charters*, CLOAKING INEQUITY (July 29, 2016), <https://cloakinginequity.com/2016/07/29/breaking-news-naacp-calls-for-national-moratorium-on-charters> [<https://perma.cc/UX8N-T27Y>].

227. *Id.*

228. *Id.*

229. *See, e.g.*, ALA. CODE § 16-6F-6(g)(5) (2017); ARK. CODE ANN. § 6-23-505 (West 2017) (requiring audits to comply with generally accepted auditing principles); CAL. EDUC.

Table 1: Entities That Perform Charter School Audits

Entity Performing Audit	State
<b>Independent Auditor</b>	Alabama, <sup>230</sup> Arizona, <sup>231</sup> Arkansas, <sup>232</sup> California, <sup>233</sup> Colorado, <sup>234</sup> Connecticut, <sup>235</sup> Delaware, <sup>236</sup> D.C., <sup>237</sup> Florida, <sup>238</sup> Hawaii, <sup>239</sup> Idaho, <sup>240</sup> Illinois, <sup>241</sup> Louisiana, <sup>242</sup> Maine, <sup>243</sup> Massachusetts, <sup>244</sup> Michigan, <sup>245</sup> Minnesota, <sup>246</sup> Missouri, <sup>247</sup> Nevada, <sup>248</sup> New Hampshire, <sup>249</sup> New Jersey, <sup>250</sup> New York, <sup>251</sup> North Carolina, <sup>252</sup>

CODE § 47605(b)(5)(I) (West 2017) (requiring audits to comply with generally accepted accounting principles); COLO. REV. STAT. ANN. § 22-30.5-104(4)(a) (West 2017) (stating that audits must comply with state department of education requirements); DC CODE § 38-1802.04 9(c)(11)(B)(ix) (2017) (stating that audits must comply with standards issued by U.S. Comptroller General); HAW. REV. STAT. ANN. § 302D-32 (West 2017) (requiring audits to comply with standards set by authorizer and state department).

230. ALA. CODE § 16-6F-10(b)(4)(b) (2017).

231. ARIZ. REV. STAT. ANN. § 15-914(D) (2017).

232. ARK. CODE ANN. § 6-23-505 (West 2017).

233. CAL. EDUC. CODE § 47605(b)(5)(I) (West 2017).

234. COLO. REV. STAT. ANN. § 22-30.5-111.7(1)(a) (West 2017).

235. CONN. GEN. STAT. ANN. § 10-66qq (West 2017).

236. DEL. CODE ANN. tit. 14, § 513(d)(1) (West 2017).

237. D.C. CODE § 38-1802.04 9(c)(11)(B)(ix) (2017).

238. FLA. STAT. ANN. § 1022.33(9)(g)(4)(j)(1) (West 2017).

239. HAW. REV. STAT. ANN. § 302D-32 (West 2017).

240. IDAHO CODE ANN. § 33-5205C(6) (West 2017).

241. 105 ILL. COMP. STAT. ANN. 5/27A-5(f) (West 2017).

242. LA. ADMIN. CODE tit. 29, pt. CXXXIX, § 2507(A) (2017).

243. ME. REV. STAT. ANN. tit. 20-a § 2412-A(3) (2017)

244. MASS. GEN. LAWS. ANN. ch. 71, § 89(jj) (West 2017).

245. MICH. COMP. LAWS ANN. § 380.503(6)(g) (West 2017).

246. MINN. STAT. ANN. § 124E.16 (subdiv. 1)(d) (West 2017).

247. MO. CODE OF STATE REGS. tit. 5, § 20-100.250(4)(B)(1) (2017).

248. NEV. REV. STAT. § 388A.105(8)(a) (West 2017).

249. N.H. REV. STAT. ANN. § 194-B:10(II) (2017).

250. N.J. STAT. ANN. § 18A:23-1 (West 2017).

251. N.Y. EDUC. LAW § 2851(2)(f) (McKinney 2017).

252. Every charter school in North Carolina is subject to audit requirements that are established by the state department of education. N.C. GEN. STAT. ANN. § 115C-218.30(a) (West 2017). The state department requires charter schools to contract with independent auditing firms to conduct annual audits. DIV. OF SCH. BUS., N.C. DEP'T OF PUB. INSTRUCTION,

	Oklahoma, <sup>253</sup> Oregon, <sup>254</sup> Pennsylvania, <sup>255</sup> South Carolina, <sup>256</sup> Texas, <sup>257</sup> Utah, <sup>258</sup> Washington <sup>259</sup>
<b>Independent Auditor or Regulatory Agency</b>	Georgia, <sup>260</sup> Indiana, <sup>261</sup> Iowa, <sup>262</sup> Mississippi, <sup>263</sup> New Mexico, <sup>264</sup> Ohio, <sup>265</sup> Tennessee <sup>266</sup>

FINANCIAL GUIDE FOR CHARTER SCHOOLS 24 (2017), <http://www.ncpublicschools.org/docs/fbs/finance/reporting/guides/charterschoolfinance.pdf> [<https://perma.cc/R8BT-SK2J>].

253. Oklahoma charter schools are subject, to the extent possible, to the same financial rules that apply to school districts. OKLA. STAT. ANN. tit. 70, § 3-136(6) (West 2017). The state's public school audit statute provides that independent accounting firms must perform audits for school districts. *Id.* § 22-104.

254. A charter school in Oregon (except for a charter school in a school district composed of one school or a charter school that is a "remote and necessary school district") must have an annual audit prepared in accordance with the state municipal audit law. OR. REV. STAT. § 338.095(3) (West 2017). According to the municipal audit law, these audits and reviews must be made by accountants in accordance with contracts agreed to by the governing body of the charter school. These audits will look into accounting methods, the legality of transactions, and compliance with requirement, orders, and regulations. *Id.* § 297.425.

255. 24 PA. STAT. AND CONS. STAT. ANN. § 2-218(a) (West 2017).

256. South Carolina's charter school statute requires charter schools to comply with the same auditing requirements as public schools. S.C. CODE ANN. § 59-40-50(B)(3) (2017). The state's administrative regulations provide that all public schools must undergo an audit by a certified public accountant. S.C. CODE ANN. REGS. 43-172(II) (2017).

257. 19 TEX. ADMIN. CODE § 100.1047(c) (2017).

258. UTAH ADMIN. CODE r. 277-113(C)(6) (2017).

259. A charter school in Washington must contract for an independent auditor after the first year of school's operation and every three years thereafter. WASH. REV. CODE ANN. § 28A.710.030(2) (West 2017).

260. GA. CODE ANN. § 20-2-2065(b)(7) (West 2017).

261. IND. CODE ANN. § 5-11-1-9(a) (West 2017).

262. Iowa charter schools are subject to the same financial audits, audit procedures, and audit requirements as school districts. IOWA CODE ANN. § 256F.4(2)(f) (West 2017). Audits are performed by either certified public accountants or the auditor of the state. *Id.* § 11.6(1)(a)(1).

263. MISS. CODE ANN. § 37-28-57(2) (West 2017).

264. Each charter school in New Mexico must have an annual audit that complies with the state audit act and rules established by the state auditor. N.M. STAT. ANN. § 22-8-13.1(A) (West 2017). The Audit Act provides that agencies may be annually audited by "the state auditor, personnel of the state auditor's office designated by the state auditor or independent auditors approved by the state auditor." *Id.* § 12-6-3(A).

265. OHIO REV. CODE ANN. § 3314.50 (West 2017).

266. Tennessee charter schools are subject to state audit procedures and audit requirements. TENN. CODE ANN. § 49-13-111 (West 2017). The charter school board must obtain an annual audit of the charter school, which may be prepared by certified public accountants or the department of audit. *Id.* § 49-13-127(b)(1).

<b>Entity Not Specified</b>	Alaska, <sup>267</sup> Kansas, <sup>268</sup> Maryland, <sup>269</sup> Rhode Island, <sup>270</sup> Virginia, <sup>271</sup> Wisconsin, <sup>272</sup> Wyoming <sup>273</sup>
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As Table 1 shows, in twenty-nine states and the District of Columbia, an independent auditor performs the annual audit. Seven states provide a choice between an independent auditor or a regulatory agency, such as the state auditor's office. Finally, in seven states the entity performing the audit is not specified.

The five cases that we summarized in the prior part occurred in states that require independent auditors to conduct annual audits: California (AIMS and Ivy Academia);<sup>274</sup> Michigan (GTA);<sup>275</sup> Missouri (Imagine Schools);<sup>276</sup> and Pennsylvania (PA Cyber).<sup>277</sup> We found scant evidence of the auditors' detecting and questioning the related-party transactions that we discussed. In three instances, the auditors' failure might have been due to the fact that they were compromised, as was the case with Enron's firm, Arthur Andersen. In the case of the AIMS scandal, the founder's wife assisted with the annual audit through a private company that she owned.<sup>278</sup> With respect to GTA, the initial accounting firm, which found nothing wrong with the prepayments to Ingersoll's EMO, represented both entities.<sup>279</sup> In the case of PA Cyber, the auditor general found that the charter school's accounting firm was eventually "absorbed" by the EMO.<sup>280</sup> These examples show that authorizers must take great care to ensure that the auditors conducting the audit are truly independent.

These auditors might have also performed poorly because they failed to consider the possibility that the charter school officials were deliberately using related-party transactions to defraud their charter schools.<sup>281</sup> Auditors of other charter schools with business partnerships should address this possible shortcoming by examining these

267. ALASKA STAT. ANN. § 14.03.255(c)(6) (West 2017).

268. KAN. STAT. ANN. § 72-1906 (c)(9) (West 2017).

269. MD. CODE ANN., EDUC. § 9-110(a)(2)(iv) (West 2017).

270. R.I. GEN. LAWS § 16-77.2-2(a)(15) (West 2017).

271. VA. CODE ANN. § 22.1-212.8(B)(26) (West 2017).

272. WIS. STAT. ANN. § 118.40 (1m)(b)(11) (West 2017).

273. WYO. RULES & REGS. EDUC. GEN. Ch. 32 § 16(a)(viii)(E)(I) (West 2017).

274. CAL. EDUC. CODE § 47605(b)(5)(I) (West 2017).

275. MICH. COMP. LAWS ANN. § 380.503(6)(g) (West 2017).

276. MO. CODE OF STATE REGS. tit. 5, § 20-100.250(4)(B)(1) (2017).

277. 24 PA. STAT. AND CONS. STAT. ANN. § 2-218(a) (West 2017).

278. FISCAL CRISIS & MGMT. ASSISTANCE TEAM, *supra* note 172, at 26.

279. U.S. v. Ingersoll, No. 14-CR-20216 (E.D. Mich. Sep. 22, 2016), <http://www.leagle.com/decision/In%20FDCCO%2020160922F83/U.S.%20v.%20INGERSOLL> [<https://perma.cc/C4JG-AGYJ>].

280. PA. DEP'T OF THE AUDITOR GEN., *supra* note 196, at 22.

281. AM. INST. OF CERTIFIED PUB. ACCOUNTING, AU SECTION 316: CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT 1719, 1719 (Dec. 15, 2002), <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00316.pdf> [<https://perma.cc/JF6Z-KCWH>] (discussing the importance of auditors "exercis[ing] professional skepticism when considering the possibility that a material misstatement due to fraud could be present").

relationships to determine whether they are dangerous related-party transactions.<sup>282</sup> This focus would be consistent with the two main standards used by auditors: generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS). Both standards require auditors to consider the possible risks of fraud intrinsic to the entities that they are investigating.

GAAS refers to the standards, established by the American Institute of Certified Public Accountants (AICPA), that apply to the “ordinary audit of financial statements by the independent auditor.”<sup>283</sup> Statement on Auditing Standards (SAS) No. 99 requires auditors to conduct “brainstorming” sessions to determine how a client might be vulnerable to fraud.<sup>284</sup> SAS No. 109 requires auditors to understand the entity and its environment, evaluate the attendant risks of material misstatements, and address significant risks that require special consideration.<sup>285</sup>

Established by the U.S. Government Accountability Office (GAO), GAGAS sets the standards for auditors of governmental entities.<sup>286</sup> GAGAS requires auditors to identify any “laws, regulations, contracts or grant agreements that are significant within the context of the audit objectives.”<sup>287</sup> This consideration requires auditors to design auditing procedures “to obtain reasonable assurance of detecting instances of noncompliance.”<sup>288</sup>

Now that the OIG’s investigation has uncovered the pervasiveness of related-party transactions in the charter school sector, auditors are on notice of the dangers posed by these agreements and should adjust their auditing protocols accordingly. Because financial statement auditors generally lack the training to look for fraud, accounting firms should consider hiring forensic specialists as part of their auditing team.<sup>289</sup>

Furthermore, states should increase the capacity of state regulatory agencies to conduct regular audits of charter schools because these entities might be better equipped to detect proscribed behavior in the charter school sector than independent auditing firms. Evidence supporting this assertion comes from Ohio, one of the states that provide such a choice. The state Auditor’s Office used to audit all charter schools in Ohio, but a decade ago, the state also hired accounting firms because of budget

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282. See PUB. CO. ACCOUNT. OVERSIGHT BD., STANDING ADVISORY GROUP MEETING: FINANCIAL FRAUD 14–15 (Sept. 8–9, 2004), [https://pcaobus.org/News/Events/Documents/09082004\\_SAGMeeting/Fraud.pdf](https://pcaobus.org/News/Events/Documents/09082004_SAGMeeting/Fraud.pdf) [<https://perma.cc/H7BH-YYQP>] (detailing fraud risk factor questions associated with related-party transactions).

283. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AU SECTION 110: RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR 1593, 1593 (Nov. 1972), <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00110.pdf> [<https://perma.cc/42D2-A6P8>].

284. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS., AU SECTION 316: *supra* note 281, at 1724.

285. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AU SECTION 314: UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT 1667, 1673, 1691–94 (Dec. 15, 2006).

286. U.S. GOV’T ACCOUNTABILITY OFFICE, GOVERNMENT AUDITING STANDARDS: 2011 REVISION (Dec. 2011), <http://gao.gov/assets/590/587281.pdf> [<https://perma.cc/8ADZ-J4N2>].

287. *Id.* at 140.

288. *Id.*

289. Gin Chong, *Detecting Fraud: What Are Auditors’ Responsibilities?*, 24 J. CORP. ACCOUNT. & FIN. 47, 53 (2013).

cuts and the dramatic increase in charter schools.<sup>290</sup> A review of the more than 4200 audits conducted in 2014 found that private firms detected misspending in one of every 200 audits. By contrast, the state Auditor's Office found misspending in one of every six audits.<sup>291</sup>

States might incorporate regulatory agencies into an auditing regime by requiring them to conduct periodic audits of charter schools. For example, Delaware requires charter school authorizers to conduct audits of their charter schools every three years with the assistance of the state Department of Education.<sup>292</sup> Regulatory agencies might also conduct risk assessments of charter schools and subject those schools that are vulnerable to fraud to further audits or investigations. The statutes and regulations of three states impose such a requirement: Louisiana,<sup>293</sup> New York,<sup>294</sup> and Texas.<sup>295</sup>

Moreover, states should empower regulatory agencies to conduct discretionary audits if they suspect that fraud has occurred in a charter school. Table 2 identifies the entities that may perform these audits.

Table 2: State Regulatory Agencies That May Perform Discretionary Audits

Entity Performing Audit	State
State Auditor	Alabama, <sup>296</sup> Arizona, <sup>297</sup> Florida, <sup>298</sup> Louisiana, <sup>299</sup> Massachusetts, <sup>300</sup>

290. Doug Livingston, *Charter Schools Misspend Millions of Ohio Tax Dollars as Efforts To Police Them Are Privatized*, AKRON BEACON J. (May 30, 2015), <http://www.ohio.com/news/local/charter-schools-misspend-millions-of-ohio-tax-dollars-as-efforts-to-police-them-are-privatized-1.596318> [<https://perma.cc/Z4DU-GEXK>].

291. *Id.*

292. DEL. CODE ANN. tit. 14, § 513(h) (West 2017).

293. Louisiana's administrative code requires charter schools to be "evaluated using the financial risk assessment and the financial indicators included in the charter school performance compact." LA. ADMIN. CODE tit. 29, pt. CXXXIX, § 1503(C)(1) (2017). The Louisiana Department of Education further provides that it will use its "risk assessment process to identify specific charter schools for mandatory internal control procedures review." LA. DEP'T OF EDUC., LOUISIANA CHARTER SCHOOL FISCAL OVERSIGHT POLICY 3.

294. N.Y. GEN. MUN. LAW § 33(2) (McKinney 2017).

295. TEX. ADMIN. CODE tit. 19, § 109.25(c) (2017).

296. ALA. CODE § 16-13A-7(d) (2017).

297. ARIZ. REV. STAT. ANN. § 15-239(D) (2017).

298. While we found no statutory or regulatory provision granting a state regulatory agency the authority to perform audits, the Florida Office of Chief Auditor (OCA) has performed audits of charter schools. *See, e.g.*, FLA. OFFICE OF CHIEF AUDITOR, AUDIT OF THE OPERATIONS OF THE SOUTH FLORIDA VIRTUAL CHARTER SCHOOL BOARD, INC. (2016), <http://www.broward.k12.fl.us/auditdept/auditcommittee/2015-16/2016-0121/ac-2016-0121-operations-southfl-virtual-charter.pdf> [<https://perma.cc/3S87-8J57>].

299. The Louisiana enabling statute requires charter schools to be subject to the financial auditing requirements that are imposed by the audit statute. LA. REV. STAT. ANN. § 17:3996(F) (2017). The financial audit statute empowers the legislative auditor to examine, audit and review the books and accounts of charter schools. LA. STAT. ANN. § 24:513(A)(1)(a) (2017).

300. MASS. GEN. LAWS. ANN. ch. 71, § 89(jj) (West 2017).

	Minnesota, <sup>301</sup> New York, <sup>302</sup> North Carolina, <sup>303</sup> Oklahoma, <sup>304</sup> Ohio, <sup>305</sup> Pennsylvania, <sup>306</sup> Tennessee, <sup>307</sup> Washington <sup>308</sup>
<b>SEA</b>	Alaska, <sup>309</sup> Arizona, <sup>310</sup> Delaware, <sup>311</sup> Iowa, <sup>312</sup> Michigan, <sup>313</sup> Minnesota, <sup>314</sup> Oklahoma, <sup>315</sup> Texas <sup>316</sup>
<b>Special Agency</b>	California <sup>317</sup>
<b>No State Regulatory Agency Specified</b>	Arkansas, Colorado, Connecticut, DC, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Maine, Maryland, Mississippi, Missouri, New Jersey, <sup>318</sup> New Hampshire, New

301. MINN. STAT. ANN. § 124E.16 (subdiv. 1)(a) (West 2017) (state or legislative auditor).

302. N.Y. EDUC. LAW § 2854(c) (McKinney 2017).

303. N.C. GEN. STAT. ANN. § 147-64.6(c)(2) (West 2017).

304. OKLA. STAT. ANN. tit. 70, § 3-136(6) (West 2017).

305. In May 2015, the Ohio Auditor of State created the Public Integrity Assurance Team (PIAT), which has the authority to investigate fraud in governmental entities. Press Release, Ohio Audit. State, ANNUAL REPORT 2016 at 16 (2016), <https://ohioauditor.gov/publications/2016%20annual%20report.pdf> [<https://perma.cc/V8NH-JPZC>]. A PIAT investigation of the Directions Academy led to the conviction and sentencing of the charter school founder after it discovered that the founder had misappropriated funds earmarked to start the school. OHIO AUDITOR OF STATE, Charter School Operator Sent to Prison for Taking Funds Earmarked for Start-up School (Nov. 28, 2016), <https://ohioauditor.gov/news/pressreleases/Details/3305> [<https://perma.cc/VW9X-SBAU>].

306. 72 PA. STAT. ANN. § 403 (West 2017).

307. TENN. CODE ANN. § 49-13-127(a) (West 2017).

308. WASH. REV. CODE ANN. § 28A.710.030(2) (West 2017).

309. ALASKA ADMIN. CODE tit. 4, § 33.115 (2017).

310. ARIZ. REV. STAT. ANN. § 15-239(C) (2017).

311. DEL. CODE ANN. tit. 14, § 513(d)(1) (West 2017).

312. Iowa charter schools are subject to the same financial audits, audit procedures, and audit requirements as school districts. IOWA CODE ANN. § 256F.4(2)(f) (West 2017). Because of this authorization, the state department of education may request a state audit when it is apparent that such an audit should be made. *Id.* § 256.9(19).

313. MICH. COMP. LAWS ANN. § 380.1281(2) (West 2017).

314. MINN. STAT. ANN. § 124E.16 (subdiv. 1)(a) (West 2017).

315. OKLA. STAT. ANN. tit. 70, § 3-136(6) (West 2017).

316. 19 TEX. ADMIN. CODE § 100.1029(a) (2017).

317. CAL. EDUC. CODE § § 42127.8 (West 2017).

318. The New Jersey administrative code stipulated that a charter school that had been subject to an audit by the department's Office of Fiscal Accountability and Compliance

	Mexico, Nevada, Oregon, Rhode Island, South Carolina, Utah, Virginia, Washington, Wisconsin, Wyoming
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As Table 2 shows, eighteen states empower their state auditors to perform discretionary audits. Thirteen states grant this power to their state auditors. Eight states give this authority to their SEAs, such as their departments or boards of education. Three states grant discretionary auditing authority to charter school authorizers. Three states permit either the state auditor or SEA to perform discretionary audits: Arizona,<sup>319</sup> Minnesota,<sup>320</sup> and Oklahoma.<sup>321</sup> We found no evidence of such authority for twenty-six states and the District of Columbia.

Additionally, California has created a special agency with discretionary authority to audit charter schools. The state's FCMAT is a state agency that helps "local educational agencies fulfill their financial and management responsibilities."<sup>322</sup> Pursuant to this responsibility, a county superintendent may request FCMAT to perform an "extraordinary audit" if that individual "has reason to believe that fraud, misappropriation of funds, or other illegal fiscal practices have occurred that merit examination."<sup>323</sup>

In New York, charter schools have twice successfully sued to prevent the legislature from subjecting them to discretionary audits by the state comptroller, which also applied to the state's traditional public schools. In each instance, the charter schools prevailed by asserting that they were more private than the institutions that the state constitution authorized the comptroller to audit.<sup>324</sup> Charter school advocates claimed that discretionary audits by governmental entities are redundant because charter schools are also subject to annual independent audits—which we have shown is a dubious assertion.<sup>325</sup> The legislature responded to each decision by amending the statute to fulfill state constitutional requirements.<sup>326</sup> At the present time, the city

(OPAC) had to discuss the findings of the audit at a public meeting of the charter school's board of trustees. The board also had to approve a corrective plan to address the findings. However, this code provision expired on November 25, 2016. N.J. ADMIN. CODE § 6A:23A-22.7 (West 2017).

319. ARIZ. REV. STAT. ANN. § 15-239(D) (2017) (permitting a state auditor); *id.* § 15-239(C) (permitting SEA).

320. MINN. STAT. ANN. § 124E.16 (subdiv. 1)(a) (West 2017).

321. OKLA. STAT. ANN. tit. 70, § 3-136(6) (West 2017).

322. FISCAL CRISIS MGMT. & ASSISTANCE TEAM, *supra* note 173.

323. CAL. EDUC. CODE § 1241.5(b) (West 2017).

324. N.Y. Charter Sch. Ass'n v. DiNapoli, 991 N.E.2d 991 (N.Y. 2009) (finding that charter schools were not political subdivisions); Success Acad. Charter Sch.—NYC v. DiNapoli, No. 3708-13 (N.Y. Sup. Ct. Mar. 12, 2014) (finding that charter schools are neither political subdivisions nor public corporations).

325. Rick Karlin, *Judge Bars Comptroller Audit of Charter Schools*, TIMES UNION (Mar. 14, 2014), <http://www.timesunion.com/local/article/Judge-bars-comptroller-audit-of-charter-schools-5319373.php> [https://perma.cc/8BQ2-7E3E.]

326. For a discussion of these cases, please see Preston C. Green, III & Joseph O. Oluwole, *An Analysis of the New York Charter School Auditing Cases*, 319 ED. LAW REP. 1 (2014).

comptroller has the authority to audit charter schools in New York City, while the state comptroller may perform discretionary audits on the rest of the state's charter schools.<sup>327</sup>

### B. Charter School Governing Boards

Charter school governing boards also serve as gatekeepers who have the responsibility of providing financial oversight over charter schools. In many states, these boards are made up of private citizens.<sup>328</sup> In all of the instances covered in the prior part, charter school governing boards failed in their gatekeeping duty. In the case of the PA Cyber scandal, conflicts of interest played a major role in the governing board's failure. The state auditor general's audit revealed that the son of one board member was the director of operations of PA Cyber's EMO.<sup>329</sup> PA Cyber paid a computer company owned by a third board member more than \$1.1 million in one year, but the governing board failed to disclose that member's connection to the company.<sup>330</sup>

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327. N.Y. EDUC. LAW § 2854(c) (McKinney 2017). After the state legislature addressed the constitutional issues raised in *Success Academy Charter Schools—NYC*, the city comptroller announced that he would audit the plaintiff in that case, a network of thirty-two charter schools serving 14,000 students in New York City. Geoff Decker, *Success Academy Charter Schools Among First To Be Audited by Comptroller*, CHALKBEAT NEW YORK (Oct. 30, 2014); SUCCESS ACADEM. CHARTER SCHS., *Who We Are*, <http://www.successacademies.org/about> [<https://perma.cc/QVM9-CH42>]. In December 2016, the city comptroller released the results of that audit. SCOTT M. STRINGER, CITY OF NYC OFFICE OF THE COMPTROLLER, AUDIT REPORT OF SUCCESS CHARTER SCHOOL-NYC'S OVERSIGHT OF FINANCIAL OPERATIONS (2016), [https://comptroller.nyc.gov/wp-content/uploads/documents/FK15\\_092A.pdf](https://comptroller.nyc.gov/wp-content/uploads/documents/FK15_092A.pdf) [<https://perma.cc/8276-EBWH>]. The audit found several questionable related-party transactions. *Id.* at 40–41. For instance, the audit revealed that Success Academy had failed to document and obtain the required approval for \$2.7 million in loans from the EMO. *Id.* at 40. Success Academy stated that these agreements had never existed in written form. Despite this lack of a written record, the school's governing board voted to approve these loans retroactively. *Id.* The audit also revealed that the EMO had obtained three loan agreements from a private foundation totaling \$6.45 million, which the EMO, in turn, passed through to Success Academy. One of these agreements between the EMO and the private foundation provided the potential for \$1 million in loan forgiveness. However, Success Academy provided no documentation assuring that the EMO had passed on this favorable term to Success Academy. *Id.* at 41. Therefore, the EMO had the potential of gaining revenue from the loan it had made to the corporation. *Id.* Success Academy responded to the audit's findings by proclaiming that its auditor BDO "is the fifth-largest accounting firm in the world and serves as the auditor of scores of Fortune 500 companies." *Id.* at Addendum, p.2. Success Academy also defended itself by observing that BDO had consistently given it "a clean bill of health with respect to its financial practices." *Id.* While we are not questioning BDO's status as a first-rate auditor, its failure to identify the related-party issues caught by the comptroller demonstrates the need for discretionary audits by regulatory bodies.

328. Preston C. Green, III, Bruce D. Baker & Joseph O. Oluwole, *Having it Both Ways: How Charter Schools Try To Obtain Funding of Private Schools and the Autonomy of Private Schools*, 63 EMORY L.J. 303, 304 (2013).

329. PA. DEP'T OF THE AUDITOR GEN., PERFORMANCE AUDIT, *supra* note 196, at 19.

330. *Id.* at 21.

Auditor General Eugene DePasquale was highly critical of the various related-party deals that were uncovered in the audit. Because of the “various and assorted deals and agreements,” he noted, “it leaves one to question who is benefiting, students or the adults making the deals.”<sup>331</sup> DePasquale was further troubled that neither the state’s charter school law nor its ethics statute prohibited governing board members from simultaneously serving as officers and board members of companies that were providing services to PA Cyber. As he explained, “such situations provide an appearance of a conflict of interest that should be mitigated.”<sup>332</sup>

We would go further than DePasquale and declare that the related-party deals uncovered by the audit were so severe that the conflicts of interests could not be “mitigated.” In fact, two states—Minnesota<sup>333</sup> and New Mexico<sup>334</sup>—forbid persons from serving on a governing board if they or their immediate family members own or have a significant stake in any entity providing “professional services, goods, or facilities” to the charter school.

In the case of Imagine Schools, the federal district court found that the governing board was subservient to the EMO because the EMO recruited the board members and then had the board sign an operating agreement that allocated all tax revenues received by the board to the EMO.<sup>335</sup> Indeed, the EMO obtained “pre-signed, undated resignation letters from board members at the time they joined the a [sic] board so that board members could be expelled at any time [they] asserted too much authority.”<sup>336</sup>

The charter school statutes and regulations of nine states address this predicament by specifically requiring charter schools to be structurally independent from their EMOs. These states are Colorado,<sup>337</sup> Connecticut,<sup>338</sup> Illinois,<sup>339</sup> Indiana,<sup>340</sup> Maine,<sup>341</sup>

331. Press Release, Pa. Dep’t Audit. Gen., Auditor General DePasquale Says Audits of PA Cyber Charter School, Two Other Schools Reaffirm Need to Overhaul Charter School Law (Sept. 22, 2016), <http://www.paauditor.gov/press-releases/auditor-general-depasquale-says-audits-of-pa-cyber-charter-school-two-other-schools-reaffirm-need-to-overhaul-charter-school-law> [<https://perma.cc/TA6T-62NF>].

332. *Id.* The ethics statutes of other states may prohibit persons from membership on charter school governing boards if they or their immediate family members are serving on the boards of entities that are providing services to the schools. Therefore, states should specifically require charter schools to comply with their states’ ethics statutes. Five states require charter schools to comply with state ethics statutes: (1) Florida (FLA. STAT. ANN. § 1022.33(9)(j)(4) (West 2017)); (2) Idaho (IDAHO STAT. § 33-5204(2)(c) (West 2017)); (3) Massachusetts (603 MASS. CODE REGS. 1.06(2)(e) (West 2017)); (4) Nevada (NEV. REV. STAT. § 388A.246(20) (West 2017)); and (5) New Jersey (N.J. ADMIN. CODE § 6A:11-3.1(a) (West 2017)).

333. MINN. STAT. ANN. § 124E.07(subdiv. 3)(a) (West 2017).

334. N.M. STAT. ANN. § 22-8B-5.2(A) (West 2017).

335. Renaissance Acad. for Math & Sci. of Mo., No. 4:13-CV-00645-NKL, at 4.

336. *Id.*

337. COLO. REV. STAT. § 22-30.5-104(4)(b) (West 2017).

338. CONN. GEN. STAT. ANN. § 10-66tt(e) (West 2017).

339. 105 ILL. COMP. STAT. § 5/27A-10.5(e) (West 2017).

340. IND. CODE ANN. § 20-24-3-2.5(4) (West 2017).

341. 05-071 ME. CODE R. Ch. 140, § 2(8) (West 2017).

Michigan,<sup>342</sup> Mississippi,<sup>343</sup> Nevada,<sup>344</sup> and Rhode Island.<sup>345</sup> Further, these states provide indicia for determining whether a charter school governing board is independent from its EMO:

The EMO must not select the members of the governing board;<sup>346</sup>

The governing board must select, retain, and compensate the attorney and auditing firm representing the board;<sup>347</sup>

The governing board and the EMO must reach the terms of the service contract through arms-length negotiations;<sup>348</sup>

The EMO must not have control over financial decisions;<sup>349</sup>

The fees for services must be reasonable;<sup>350</sup> and

Other agreements between the governing board and the EMO must align with market rates and not change if the contract is terminated.<sup>351</sup>

Furthermore, charter school governing boards should receive training with respect to their supervisory responsibilities. The Imagine Schools, AIMS, and Ivy Academia instances reveal that their governing boards failed to grasp the extent of their oversight responsibilities. For instance, one board member testified at trial that he erroneously believed that “Imagine Schools had authority over the Renaissance Board.”<sup>352</sup> This testimony led the court to describe the member as being “very confused” about his board duties.<sup>353</sup> Similarly, in the Ivy Academia case, the trial court characterized the president of the board of directors in the following manner: “[F]rankly, having him on the board of directors was like having nobody on the board of directors.”<sup>354</sup> With respect to the AIMS charter schools, FCMAT concluded that “[t]here was little evidence of responsible governance by the board,”<sup>355</sup> and “[t]he governing board has failed to maintain and exercise its responsibilities, authority, and control.”<sup>356</sup>

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342. MICH. COMP. LAWS ANN. § 380.507(1)(f) (West 2017).

343. 10-402 MISS. CODE R. § 1.12(D) (West 2017).

344. NEV. REV. STAT. § 388A.393(1)(a) (West 2017).

345. 21-2-58 R.I. CODE R. § C-7-1(c) (West 2017).

346. 05-071 ME. CODE R. Ch. 140, § 2(8)(A).

347. CONN. GEN. STAT. ANN. § 10-66tt(e); 05-071 ME. CODE R. Ch. 140, § 2(8)(B); 21-2-58 R.I. CODE R. § C-7-1(c).

348. IND. CODE ANN. § 20-24-3-2.5(4); 05-071 ME. CODE R. Ch. 140, § 2(8)(C); 10-402 MISS. CODE R. § 1.12(D)(1).

349. NEV. REV. STAT. § 388A.393(1)(a).

350. 05-071 ME. CODE R. Ch. 140, § 2(8)(D).

351. *Id.* at § 2(8)(E).

352. Renaissance Acad. for Math & Sci. of Mo., No. 4:13-CV-00645-NKL, at 3.

353. *Id.* at 4.

354. Brief for Respondent at 34, *People v. Selivanov*, 210 Cal. Rptr. 3d 117 (Ct. App. 2016) (No. B252894), [http://www.ccsa.org/2015-04-29-Selivanov-People\\_Respondent's\\_Brief\\_Embezzlement.pdf](http://www.ccsa.org/2015-04-29-Selivanov-People_Respondent's_Brief_Embezzlement.pdf) [<https://perma.cc/GS8X-JPAE>].

355. FISCAL CRISIS & MGMT. ASSISTANCE TEAM., *supra* note 172, at 34.

356. *Id.*

Thirteen states require governing boards to receive training: Colorado,<sup>357</sup> Delaware,<sup>358</sup> Florida,<sup>359</sup> Georgia,<sup>360</sup> Massachusetts,<sup>361</sup> Minnesota,<sup>362</sup> Mississippi,<sup>363</sup> Nevada,<sup>364</sup> New Jersey,<sup>365</sup> New Mexico,<sup>366</sup> Tennessee,<sup>367</sup> Texas,<sup>368</sup> and Wisconsin.<sup>369</sup> Five of these states—Delaware, Florida, Minnesota, New Mexico, and Texas—specifically include coverage of financial management in their training provisions. In addition to training requirements, states should require governing boards to possess expertise in financial management. Only three states—Hawaii,<sup>370</sup> Louisiana,<sup>371</sup> and South Carolina<sup>372</sup>—impose this requirement on their charter school governing boards.

Finally, the examples of related-party transactions in Part III.B of this Article show that governing boards should receive guidance regarding leasing arrangements. In the *Imagine Schools* and *Ivy Academia* cases, the governing boards approved leases that were egregiously disadvantageous to the charter schools they represented. Maine and New Jersey have administrative code provisions that cover charter school leases. Maine’s administrative code provides that “loans or leases between the charter school and the education service provider [must be] fair and reasonable, documented appropriately, align with market rates, and include terms that [they] will not change if the contract is terminated.”<sup>373</sup> New Jersey’s administrative code cautions that governing boards should ensure that leases: (1) “[do] not exceed the length of the charter”;<sup>374</sup> (2) “contain[] a provision terminating the obligation to pay rent upon the denial, revocation, non-renewal, or surrender of the charter”;<sup>375</sup> and (3) “[do] not contain a provision accelerating the obligation to pay rent in the event of default.”<sup>376</sup>

357. 1 COLO. CODE REGS. § 301-88.2.01(C) (West 2017).

358. DEL. CODE ANN. tit. 14, § 1803 (West 2017).

359. FLA. STAT. ANN. § 1022.33(9)(j)(4) (West 2017).

360. GA. CODE ANN., § 20-2-2084(f) (West 2017).

361. 603 MASS. CODE REGS. 1.06 (2017).

362. MINN. STAT. ANN. § 124E.07(Subdiv. 7) (West 2017).

363. 10-402 MISS. CODE REGS. § 2.5 (West 2017).

364. NEV. REV. STAT. § 388A.246(20) (West 2017).

365. N.J. ADMIN. CODE § 6A:32-3.2(a)(2) (West 2017).

366. N.M. STAT. ANN. § 22-8B-5.1 (West 2017).

367. TENN. CODE ANN. § 49-13-111(o) (West 2017).

368. TEX. EDUC. CODE § 12.123 (West 2017).

369. WIS. STAT. ANN. § 118.40 (2r)(2)(j) (West 2017); WIS. STAT. ANN. § 118.40 (2x)(2)(j) (West 2017).

370. HAW. REV. STAT. § 302D-12(b)(3) (West 2017).

371. LA. ADMIN. CODE tit. 28, pt. CXXXIX, § 2101(D)(2) (2017).

372. S.C. STAT. § 59-40-50(B)(9) (2017).

373. 05-071 ME. CODE R. Ch. 140, § 2(8)(E) (West 2017).

374. N.J. ADMIN. CODE § 6A:23A-22.4(b)(1) (West 2017).

375. *Id.* § (b)(2).

376. *Id.* § (b)(3).

*C. Charter School Authorizers*

Charter school authorizers review applications to determine whether to grant charters, monitor the schools for which they are responsible, and decide whether to revoke or renew charters.<sup>377</sup> Charter school authorizers are “ultimately responsible for the fiscal oversight of each charter school they oversee.”<sup>378</sup> Their duty to ensure the fiscal health of charter schools extends “from application approval to oversight and monitoring to closure or renewal.”<sup>379</sup>

Consequently, authorizers play a pivotal role in guarding against unreasonable related-party transactions. Authorizers can better fulfill this task by reviewing all major charter school agreements including service contracts with EMOs, leasing agreements, and vending contracts. Perhaps such a review might have prevented the charter school governing boards from entering into the disastrous agreements discussed in the third part of this Article.

Five states partially address this suggestion by specifically requiring authorizers to review the service agreements between EMOs and charter schools: Colorado, Connecticut, Illinois, Michigan, and New Mexico. Michigan’s charter school statute provides that an authorizer “must review and may disapprove any agreement between the board of directors . . . and an educational management organization before the agreement is final and valid.”<sup>380</sup> New Mexico provides that the authorizer must review contracts with a “third-party provider” and assess the charter school’s financial independence from the provider.<sup>381</sup> Colorado and Illinois require authorizers to enforce the following requirements for “any school contracting with a third-party provider for educational design and operation or management”: (1) including contractual provisions that affirm the rigorous independence of the governing board’s oversight authority; (2) adding provisions that ensure that the school and the external provider are financially independent from each other; and (3) reviewing the proposed contract “as a condition of charter approval to ensure that it is consistent with applicable law, authorizer policy and the public interest.”<sup>382</sup>

Connecticut’s charter school statute requires the state board of education, which is the state’s authorizer, to review and approve “any contract for whole school management services” before the contract takes effect.<sup>383</sup> As part of the review, the authorizer must “solicit and review comments . . . from the local or regional board of

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377. Sandra Vergari, *Charter School Authorizers: Public Agents for Holding Charter Schools Accountable*, 33 *EDUC. & URB. SOC.* 129, 132 (2001).

378. NAT’L CHARTER SCH. RES. CTR., *A USER’S GUIDE TO FISCAL OVERSIGHT: A TOOLKIT FOR CHARTER SCHOOL AUTHORIZERS 2* (2016), [https://www.charterschoolcenter.org/sites/default/files/Fiscal%20Oversight%20Toolkit%20-%20Authorizers%20\(1\).pdf](https://www.charterschoolcenter.org/sites/default/files/Fiscal%20Oversight%20Toolkit%20-%20Authorizers%20(1).pdf) [https://perma.cc/6EZ9-T5ZD].

379. *Id.*

380. MICH. COMP. LAWS ANN. § 380.503(n) (West 2017).

381. N.M. STAT. ANN. § 22-8B-9(B)(14) (West 2017).

382. 1 COLO. CODE REGS. §§ 301-88:3.04(D)(1), (D)(2) (West 2017); ILL. ADMIN. CODE tit. 23, § 650 App. A (West 2017).

383. CONN. GEN. STAT. ANN. § 10-66tt(c) (West 2017).

education of the town in which the charter school is located or in which the proposed charter school is to be located.”<sup>384</sup>

While we laud these states for requiring authorizers to review service agreements with EMOs, we suggest that even these states can improve their provisions by including lease agreements and vending contracts. As the related-party transaction examples provided in the third part of this Article make clear, the categories “education design and operation” or “whole management services” are not the only contracts that can be against the “public interest.”

States can also receive guidance from national authorizing entities, such as the National Association of Charter School Authorizers (NACSA), in developing approaches for reviewing related-party transactions. NACSA has published a guide titled, *Principles and Standards for Quality Authorizing*, which provides advice for contracts with EMOs.<sup>385</sup> This publication advises authorizers to require that such contracts include mandatory authorizer review and approval as a prerequisite for granting charters. The publication also suggests that education service or management agreements articulate “[a]ll compensation to be paid to the provider, including all fees [and] bonuses”<sup>386</sup> as well as the “[t]erms of any facility agreement that may be part of the relationship.”<sup>387</sup>

Eleven states require authorizers to adopt national standards for charter school oversight and evaluation: Alabama,<sup>388</sup> Colorado,<sup>389</sup> Illinois,<sup>390</sup> Louisiana,<sup>391</sup> Maine,<sup>392</sup> Mississippi,<sup>393</sup> Nevada,<sup>394</sup> South Carolina,<sup>395</sup> Tennessee,<sup>396</sup> Washington,<sup>397</sup> and Wisconsin.<sup>398</sup> While Colorado and Illinois’ contractual review provisions, discussed earlier in this subpart, are direct quotes from the NACSA’s *Principals and Standards* publication,<sup>399</sup> the statutes and regulations of the remaining states provide no elaboration about contract review. We hope that these states—and others—also adopt the contractual review guidance provided by national authorizer entities, taking special care to include authorizer review of vending contracts that do not fall under the category of agreements for comprehensive services or management.

384. *Id.*

385. NAT’L ASS’N OF CHARTER SCH. AUTHORIZERS, PRINCIPLES & STANDARDS FOR QUALITY CHARTER SCHOOL AUTHORIZING (2015 ed.), [http://www.qualitycharters.org/wp-content/uploads/2015/08/Principles-and-Standards\\_2015-Edition.pdf](http://www.qualitycharters.org/wp-content/uploads/2015/08/Principles-and-Standards_2015-Edition.pdf) [<https://perma.cc/ZGF8-TGTT>].

386. *Id.* at 24.

387. *Id.*

388. ALA. CODE § 16-6F-6(r) (2017).

389. 1 COLO. CODE REGS. §§ 301-88:3.02(B)(2), 302(C)(1) (West 2017).

390. ILL. ADMIN. CODE tit. 23, § 650 App. A (West 2017).

391. LA. REV. STAT. ANN. § 17:3981(4) (2017).

392. ME. REV. STAT. ANN. tit. 20-a, § 2405(3) (2017).

393. MISS. CODE ANN. § 37-28-9(1)(a) (West 2017).

394. NEV. REV. STAT. § 388A.223(2) (West 2017).

395. S.C. STAT. ANN. § 59-40-55(A) (2017).

396. TENN. COMP. R. & REGS. 0520-14-01-.02(6) (2017).

397. WASH. REV. CODE ANN. § 28A.710.100(3) (West 2017)

398. WIS. STAT. ANN. § 118.40(3m)(b) (West 2017).

399. NAT’L ASS’N OF CHARTER SCH. AUTHORIZERS, *supra* note 385, at 16.

*D. State Education Agencies (SEAs)*

SEAs are charged with supervising a state's public elementary and secondary schools.<sup>400</sup> This duty encompasses “the administration of state and federal funding programs.”<sup>401</sup> SEAs fulfill this responsibility “through four key activities: regulation, funding, compliance monitoring, and technical assistance.”<sup>402</sup>

The OIG's audit found that the SEAs' monitoring of charter schools' relationships with EMO was inadequate. In particular, none of the participating SEAs included procedures for identifying internal control weaknesses, including related-party transactions.<sup>403</sup> The audit also found no legislation that required the participating SEAs to provide oversight over their authorizers.<sup>404</sup> This lack of oversight might enable illegal related-party transactions to endure without detection. In our review of charter school laws, we found that Alabama<sup>405</sup> and Washington<sup>406</sup> require their SEAs to monitor charter school authorizers. Seven states—Hawaii,<sup>407</sup> Illinois,<sup>408</sup> Indiana,<sup>409</sup> Maine,<sup>410</sup> Minnesota,<sup>411</sup> Missouri,<sup>412</sup> and Ohio<sup>413</sup>—go further still by granting SEAs the power to revoke authorizing authority due to poor performance. Obviously, other jurisdictions should also grant SEAs the authority to monitor and revoke the performance of their authorizers.

In addition to the findings of the OIG audit, we recommend that SEAs coordinate with their authorizers regarding their responsibilities for investigating instances of fraud and mismanagement. The GTA example shows how authorizers and other governmental entities can fail to work together to detect unlawful activity. After the authorizer informed the Michigan Department of Education about the improper prepayments, Michael Flanagan, who was then the state superintendent of public instruction, responded in a letter agreeing that these payments might have placed the charter school at financial risk.<sup>414</sup> Nevertheless, Flanagan opined that the department had “no statutory authority to recommend any corrective actions.”<sup>415</sup> Flanagan also advised the governing board to take a series of steps, including conducting “at its

400. 34 C.F.R. § 77.1 (2017).

401. JOANNE WEISS & PATRICK MCGUINN, *THE EVOLVING ROLE OF THE STATE EDUCATION AGENCY IN THE ERA OF ESSA: PAST, PRESENT AND UNCERTAIN FUTURE* 32 (2017), <http://www.aspendrl.org/portal/browse/DocumentDetail?documentId=2958&download&admin=2958%7C1917288972> [https://perma.cc/WJV7-QF7R].

402. *Id.*

403. U.S. DEP'T OF EDUC., OFFICE OF INSPECTOR GEN., *supra* note 210, at 25.

404. *Id.* at 27.

405. ALA. ADMIN. CODE r. 290-3-6-.03(1) (2017).

406. WASH. ADMIN. CODE § 180-19-220(1) (2017).

407. HAW. REV. STAT. ANN. § 302D-11 (West 2017).

408. ILL. ADMIN. CODE tit. 23, § 650.65 (2017).

409. IND. CODE ANN. § 20-24-2.2-6 (West Supp. 2017).

410. ME. REV. STAT. ANN. tit. 20-a, § 2403(5) (2017).

411. MINN. STAT. ANN. § 124.05 (subdiv. 6) (West 2017).

412. MO. ANN. STAT. § 160.400(17)(2) (West Supp. 2017).

413. OHIO REV. CODE ANN. § 3314.015(C) (West 2017).

414. Letter from Michael P. Flanagan, State Superintendent of Pub. Instruction, to Dr. Tony McLain, Pres., Lake Superior State Univ. (May 7, 2014) (on file with authors).

415. *Id.*

own expense, . . . a forensic audit to determine what, if any, school assets have been misused or misspent.”<sup>416</sup>

As it turns out, however, Flanagan’s claim that the state department of education had no statutory authority to recommend corrective actions was incorrect. Section 380.1281 of the state’s education code specifically empowers the state board of education to “examine and audit the official records and accounts” of charter schools, and “compel proper accounting by legal action instituted by direction of the attorney general.”<sup>417</sup> Another provision of the education code transfers the statutory rulemaking and administrative powers and duties of the state board to the superintendent of public instruction for certain provisions, including section 380.1281, the provision pertinent to this case.<sup>418</sup> To protect against illegal related-party transactions, other SEAs must do a better job than the Michigan Department of Education of delineating their investigative responsibilities.

#### *E. U.S. Department of Education*

The U.S. Department of Education is the federal agency that helps the President execute his educational policies and implement congressional legislation.<sup>419</sup> The Department is also responsible for establishing policy for, administering, and coordinating federal assistance to education.<sup>420</sup> The Department has provided funding incentives to states to support the agency’s initiatives.<sup>421</sup> As we have noted in the third part of this Article, the Department has used funding incentives for more than two decades to encourage charter school growth without promoting oversight. This Article has also explained that insufficient gatekeeping might permit bad actors to use related-party transactions to defraud federal and state governments.

The OIG observed that the Department committed a critical mistake by treating charter schools with EMOs the same as other grantees. Department officials defended this oversight by asserting that the “risks posed by charter schools and [EMOs] were not materially different from the risks presented by other grantees that received Department funds.”<sup>422</sup> Consequently, the Department’s risk model

416. *Id.*

417. MICH. COMP. LAWS ANN. § 380.1281(2) (West 2017). In 1994, the state legislature amended § 380.1281(2) to include charter schools. 1994 Mich. Legis. Serv. P.A. 416 (West).

418. MICH. COMP. LAWS ANN. §§ 388.994(1)–(2) (West 2017). These provisions transferred certain administrative powers and duties from the state board of education to the superintendent of public instruction. Specifically, the legislature ordered a Type II transfer, which granted the superintendent all of the board’s “statutory authority, powers, duties and functions.” MICH. COMP. LAWS ANN. § 16.103(3)(b) (West 2017).

419. *An Overview of the U.S. Department of Education*, U.S. DEP’T OF EDUC. (Sept. 2010), [https://www2.ed.gov/about/overview/focus/what\\_pg2.html](https://www2.ed.gov/about/overview/focus/what_pg2.html) [<https://perma.cc/N5RV-QB88>].

420. *Id.*

421. See Eloise Pasachoff, *Conditional Spending After NFIB v. Sebelius: The Example of Federal Education Law*, 62 AM. U. L. REV. 577 (2013).

422. U.S. DEP’T OF EDUC., OFFICE OF INSPECTOR GEN., *supra* note 210, at 23.

failed to include “criteria indicative of the risks unique to charter school relationships with [EMOs].”<sup>423</sup> Notably, department officials failed to assess the risks connected with charter school EMO governance structures because they believed that “issues concerning the direct governance of charter schools are primarily the responsibility of the appropriate State and local governments, including charter school authorizers.”<sup>424</sup>

The OIG’s critique is reminiscent of John Kroger’s disparagement of the SEC’s oversight of Enron. According to Kroger, the SEC failed to consider the risks that Fortune 500 companies posed to the financial markets.<sup>425</sup> Similarly, the OIG faulted the Department for not taking into account the threat posed by the “unique attributes” of charter school EMO relationships.<sup>426</sup> In particular, the Department failed to consider how dramatically the charter school governance structure departs from that of traditional public schools. School districts rarely hire EMOs to run the day-to-day operations of traditional public schools.<sup>427</sup> By contrast, EMOs manage thirty-five to forty percent of all charter schools.<sup>428</sup>

We have explained elsewhere how the hiring of EMOs creates an agency issue with charter school governing boards that generally does not occur in traditional public schools.<sup>429</sup> While governing boards have the incentive to ensure that their schools are operating in a fiscally sound manner, EMOs have the incentive to increase their revenues or cut expenses in ways that may go against the goals of the governing boards.<sup>430</sup> EMOs have taken advantage of poorly trained governing boards and the lack of coordination between governing boards and authorizing bodies to benefit their interests at the expense of charter schools.<sup>431</sup> Therefore, it is imperative for the Department to ensure that the regulatory system of grantees is sufficiently robust to protect against this agency problem.

The OIG’s audit also provided recommendations that might help the Department mitigate the risks posed by related-party transactions. Specifically, the audit advised the Department to convene an oversight group that would develop strategies for helping state gatekeepers reduce the risks posed by charter school

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423. *Id.*

424. *Id.*

425. Kroger, *supra* note 2, at 108.

426. U.S. DEP’T OF EDUC., OFFICE OF INSPECTOR GEN., *supra* note 210, at 21.

427. In 2011–12, 94.6% of schools managed by EMOs were charter schools. Nearly ninety-five percent of schools managed by nonprofit EMOs were charter schools. GARY MIRON & CHARISSE GULOSINO, NAT’L EDUC. POLICY CTR., PROFILES OF FOR-PROFIT AND NONPROFIT EDUCATION MANAGEMENT ORGANIZATIONS iii–iv (14th ed. 2013), <http://nepc.colorado.edu/files/emo-profiles-11-12.pdf> [<https://perma.cc/9AB4-SGHN>].

428. BAKER & MIRON, *supra* note 116, at 7.

429. Preston C. Green, III, Bruce D. Baker, Josephe O. Oluwole & Julie F. Mead, *Are We Heading Toward a Charter School “Bubble”?: Lessons from the Subprime Mortgage Crisis*, 50 U. RICH. L. REV. 783, 796–99 (2016).

430. *Id.* We suggested that the agency problem exists for only for-profit EMOs. *Id.* In this Article, we assert that the agency problem also exists for nonprofit EMOs. *See* discussion *supra* Part III.B.1 and accompanying notes.

431. Green et al., *supra* note 429, at 798–99.

relationships with EMOs.<sup>432</sup> The group would take the following actions: (1) provide guidance to SEAs that helps them monitor and assess risk, as well as develop mitigation procedures; (2) modify the protocols for monitoring federal grants; (3) work with external parties to help SEAs and authorizers more effectively evaluate applications; and (4) collaborate with other federal agencies to update the *OMB Circular A-133 Compliance Supplement*, the document used to audit federal grant programs and their recipients.<sup>433</sup> The Department generally agreed with these recommendations.<sup>434</sup> We also agree, only advising that the OIG extend its recommendations to other related-party transactions that might have a negative impact on the Department's programs.

Furthermore, the Department should use its funding incentives to encourage greater oversight over charter schools. Now that the Department is aware of the fraud and mismanagement that exists in this sector, it would be nonsensical to continue funding charter schools without requiring states to implement strategies to protect against fraud as a requirement for funding. Otherwise, unscrupulous charter school operators will continue to pose a threat to the Department's goals.

The election of Donald J. Trump as President has placed the Department's new focus on related-party transactions in jeopardy. While on the campaign trail, Trump proposed a \$20 billion federal block grant to increase school choice options for 11 million students living in poverty.<sup>435</sup> Trump has also nominated Michigan philanthropist Betsy DeVos to be the new Secretary of Education.<sup>436</sup> DeVos, who played a role in the passage of Michigan's charter school law, fought against attempts to increase regulation of the state's charter school sector.<sup>437</sup> For example, when the Michigan legislature considered increasing oversight over Detroit's charter schools, the DeVos family donated \$1.45 million over a seven week period to the state's Republican candidates and organizations.<sup>438</sup> The final legislation did not include oversight provisions.<sup>439</sup>

432. U.S. DEP'T OF EDUC., OFFICE OF INSPECTOR GEN., *supra* note 204, at 29.

433. *Id.* at 30–31.

434. *Id.* at 31.

435. COREY TURNER & ERIC WESTERVELT, *Donald Trump's Plan for America's Schools* (Sept. 25, 2016), <https://www.npr.org/sections/ed/2016/09/25/494740056/donald-trumps-plan-for-americas-schools> [<https://perma.cc/9F7H-A6G9>].

436. Emma Brown, *Trump Picks Billionaire Betsy DeVos, School Voucher Advocate, as Education Secretary*, WASH. POST (Nov. 23, 2016), [https://www.washingtonpost.com/local/education/trump-picks-billionaire-betsy-devos-school-voucher-advocate-as-education-secretary/2016/11/23/c3d66b94-af96-11e6-840f-e3ebab6bdd3\\_story.html?utm\\_term=.caf3961799c6](https://www.washingtonpost.com/local/education/trump-picks-billionaire-betsy-devos-school-voucher-advocate-as-education-secretary/2016/11/23/c3d66b94-af96-11e6-840f-e3ebab6bdd3_story.html?utm_term=.caf3961799c6) [<https://perma.cc/E7L7-CBBT>].

437. Philissa Cramer, *What You Should Know About Betsy DeVos, Trump's Education Secretary Pick—and What Her Choice Might Tell Us About His Plans*, CHALKBEAT (Nov. 22, 2016), <http://www.chalkbeat.org/posts/us/2016/11/22/what-a-betsy-devos-appointment-would-tell-us-about-donald-trumps-education-plans/> [<https://perma.cc/ST95-U5BS>].

438. *Id.*

439. *Id.*

## CONCLUSION

This Article has explained that: (1) Enron-like related-party transactions are common in the charter school sector; and (2) gatekeepers must be equipped to guard against this type of destructive activity. We reviewed the following gatekeepers in the charter school sector: auditors, governing boards, authorizers, SEAs, and the U.S. Department of Education.

We have found that independent auditors must make detecting illegitimate related-party transactions a priority. States should also increase the capacity of regulatory bodies to conduct audits of charter schools. For instance, states could either: (1) have regulatory agencies conduct periodic audits of all charter schools; or (2) conduct risk assessments of charter schools and audit those schools most vulnerable to fraud. Finally, states should authorize regulatory bodies to conduct discretionary audits if they suspect that a charter school operator is engaging in fraud.

With respect to charter school governing boards, we recommend that states should do the following: (1) forbid persons from serving on charter school boards if they or their immediate family members have a significant financial stake in a contractor or vendor; (2) require governing boards to be structurally independent from their EMOs; (3) require board members to receive training regarding their supervisory responsibilities; and (4) require governing boards to receive specific training regarding leases.

With respect to charter school authorizers, we advise that states require them to review all vending and lease contracts and reject those that would be harmful to the charter schools' interests. Furthermore, states should: (1) require SEAs to monitor the relationships between charter schools and their contractors; and (2) coordinate with authorizers with respect to conducting investigations of suspected illegal activities.

Finally, we advise the U.S. Department of Education to do the following: (1) develop risk assessments that account for risks posed by charter school-EMO relationships; (2) develop strategies that would enable state gatekeepers to reduce the risks posed by related-party transactions; and (3) require states to implement fraud prevention programs as a prerequisite for the receipt of charter school funding.

Implementing these strategies should go a long way toward protecting charter schools from the dangers posed by related-party transactions. They will strengthen the ability of gatekeepers to ensure that state and federal funding is focused on the education of students.