

# Charter Schools, Academy Schools, and Related-Party Transactions: Same Scams, Different Countries<sup>a</sup>

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## Introduction

In the course of the last quarter century, governmental entities in both the United States and England have sought to encourage educational innovation by creating publicly funded schools that are independent from many rules that apply to locally controlled schools. These schools are called charter schools in the United States and academy schools (academies) in England.<sup>1</sup> Private companies run a high percentage of these charter schools and academies. In the United States, these companies are commonly referred to as educational management organizations (EMOs).<sup>2</sup> In England, these organizations are called academy trusts (ATs).<sup>3</sup>

EMOs and ATs frequently engage in related-party transactions for a number of services including educational technology, real estate, and consulting.<sup>4</sup> Related-party transactions are business deals between companies with special, pre-existing relationships.<sup>5</sup> These arrangements

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<sup>1</sup> Helen F. Ladd & Edward B. Fiske, *Lessons for US Charter Schools from the Growth of Academies in England*, BROOKINGS, Nov. 3, 2016, <https://www.brookings.edu/research/lessons-for-us-charter-schools-from-the-growth-of-academies-in-england/>.

<sup>2</sup> BRUCE BAKER & GARY MIRON, THE BUSINESS OF CHARTER SCHOOLING: UNDERSTANDING THE POLICIES THAT CHARTER OPERATORS USE FOR FINANCIAL BENEFIT 7 (Dec. 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).

<sup>3</sup> DEP'T FOR EDUC., GOVERNANCE HANDBOOK 2017: FOR ACADEMIES, MULTI-ACADEMY TRUSTS AND MAINTAINED SCHOOLS 43 (Jan. 2017), <https://dera.ioe.ac.uk/28078/>.

<sup>4</sup> We discuss related-party transactions in charter schools and academies in more detail in Section II.

<sup>5</sup> ART BERKOVITZ & RICHARD RAMPPELL, RELATED-PARTY TRANSACTIONS CAN BE AN INVESTMENT RED FLAG (Aug. 29, 2002), <https://www.artberkowitz.com/article7.htm>.

can occur, for example, between affiliated companies or a parent company and its subsidiaries.<sup>6</sup> Although related-party transactions are legal, they can create harmful conflicts of interest.<sup>7</sup> As a result, in both the charter and academy sectors, governmental entities have created monitoring systems to protect against wasteful and fraudulent related-party transactions.<sup>8</sup>

However, despite the existence of these monitoring systems, numerous instances of problematic related-party transactions have occurred in charter schools and academies. Using comparative legal research methodologies, this article attempts to explain why the monitoring systems of each domain are having such a difficult time regulating related-party transactions. Following an explanation of the methods, Section II investigates the prominent role EMOs and ATs play in the expansion of charter schools and academies. Subsequently, section III examines data on EMO and AT engagement in related-party transactions and presents examples of EMOs and ATs abusing the legality of these transactions. These two sections together demonstrate the need to consider how these organizations are monitored. In Section IV we then analyze the current systems in place to monitor related-party transactions in charter schools and academies and make suggestions for improvement.

## **Section I: Methodology**

To achieve the goals of this article, we apply the comparative legal research methodology of functionalism. Functionalism examines the approaches that different legal systems use to solve conflicts.<sup>9</sup> This methodology looks for “functional equivalents” that countries have

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<sup>6</sup> AM. INST. CERT. PUB. ACCOUNT., AU SECTION 334: RELATED PARTIES 1961, 1961 n.1 (Sep. 10, 2013).

<sup>7</sup> Elizabeth A. Gordon, *Related Party Transactions and Corporate Governance*, 9 CORP. GOV. ADVANCES IN FIN. ECON. 1, 7 (2004) (explaining the conflict of interest view of related-party transactions).

<sup>8</sup> We analyze these related-party-transaction monitoring systems in Section III.

<sup>9</sup> Mark Van Hoecke, *METHODOLOGY OF COMPARATIVE LEGAL RESEARCH* 1, 9, [https://www.researchgate.net/publication/291373684\\_Methodology\\_of\\_Comparative\\_Legal\\_Research](https://www.researchgate.net/publication/291373684_Methodology_of_Comparative_Legal_Research) (last visited Oct. 15, 2018).

developed to solve a particular problem.<sup>10</sup> Despite the countries' legal differences, their solutions “may be similar or even identical.”<sup>11</sup>

Functionalism is especially appropriate for the comparison made in this article because the United States and England have similar, common-law legal systems.<sup>12</sup> However, merely comparing the legal rules for each country may be insufficient because of contextual differences.<sup>13</sup> Therefore, we supplement the functional method by employing the law-in-context method.<sup>14</sup> The goal of the law-in-context method is to discern how the different legal concepts work in practice.<sup>15</sup> Thus, we have included analysis of the following materials: (1) educational, legal, and accounting research articles pertaining to charter schools and academies; (2) governmental reports and audits of charter schools and academies; and (3) media investigations of problematic related-party transactions in the charter school and academy sectors.

## **Section II: The Role that EMOs and ATs Play in the Expansion of Charter Schools and Academies**

### **A. Charter Schools**

Since 1991, 44 states and the District of Columbia have passed charter school legislation.<sup>16</sup> The argument for the initial creation of charter schools was that, with their greater flexibility, these schools could foster necessary innovations in the public education system.<sup>17</sup>

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<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 10.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 3.

<sup>14</sup> *Id.* at 16.

<sup>15</sup> *Id.*

<sup>16</sup> Micah Ann Wixon, *50-State Comparison Charter School Policies*, EDUC. COMM'N STATES (2018), <https://www.ecs.org/charter-school-policies/>.

<sup>17</sup> Claudio Sanchez, *Just What Is a Charter School, Anyway?*, Mar. 1, 2017, NPRED, <https://www.npr.org/sections/ed/2017/03/01/511446388/just-what-is-a-charter-school-anyway>.

Charter schools operate under a contract, or charter, with a charter school authorizer.<sup>18</sup> The charter specifies the organization and the management of the school as well as measures for academic success.<sup>19</sup> There are more than 7,000 charter schools that educate more than 3 million students<sup>20</sup> – 6% of the nation’s public-school population.<sup>21</sup>

Charter schools have grown steadily over the past 10 years, adding 300 to 400 schools each year.<sup>22</sup> EMO-operated charter schools have also become more prominent. EMOs are for-profit or non-profit companies that contract with charter school boards to provide educational and management services to charter schools.<sup>23</sup> In 2009-10, EMOs managed around 30% of charter schools and educated 35% of charter school students nationwide.<sup>24</sup> In 2016-17, EMOs operated 35% of all charter schools, constituting 42% of enrollment.<sup>25</sup>

The expansion of EMOs is not happenstance. In fact, charter-school proponents believe that EMOs can achieve expansion faster than stand-alone charter schools because of economies of scale and “the development expertise needed to secure financial expansion.”<sup>26</sup> Philanthropic foundations have played a significant role in promoting the growth of EMO-run charter

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> Rebecca David & Kevin Hesla, *Estimated Public Charter School Enrollment, 2017-18*, NAT’L ASS’N PUB. CHART. SCHS. (Mar. 2018), <https://www.publiccharters.org/sites/default/files/documents/2018-03/FINAL%20Estimated%20Public%20Charter%20School%20Enrollment%2C%202017-18.pdf>.

<sup>21</sup> Nat’l Ctr. Educ. Stats., *Public Charter School Enrollment*, THE CONDITION OF EDUCATION (Mar. 2018), [https://nces.ed.gov/programs/coe/indicator\\_cgb.asp](https://nces.ed.gov/programs/coe/indicator_cgb.asp).

<sup>22</sup> Sarah Cohodes, *Charter Schools and the Achievement Gap*, THE FUTURE OF CHILDREN 1 (Win. 2018), [https://futureofchildren.princeton.edu/sites/futureofchildren/files/resource-links/charter\\_schools\\_compiled.pdf](https://futureofchildren.princeton.edu/sites/futureofchildren/files/resource-links/charter_schools_compiled.pdf).

<sup>23</sup> BAKER & MIRON, *supra* note 2, at 7.

<sup>24</sup> NAT’L ALL. PUB. CH. SCHS., CMO AND EMO PUBLIC CHARTER SCHOOLS: A GROWING PHENOMENON IN THE CHARTER SCHOOL SECTOR: PUBLIC CHARTER SCHOOL DASHBOARD DATA FROM 2007-08, 20-08-09, AND 2009-10 1 (n.d.), [http://www.publiccharters.org/sites/default/files/migrated/wp-content/uploads/2014/01/NAPCS-CMO-EMO-DASHBOARD-DETAILS\\_20111103T102812.pdf](http://www.publiccharters.org/sites/default/files/migrated/wp-content/uploads/2014/01/NAPCS-CMO-EMO-DASHBOARD-DETAILS_20111103T102812.pdf).

<sup>25</sup> REBECCA DAVID, NATIONAL CHARTER SCHOOL MANAGEMENT OVERVIEW: 2016-17 SCHOOL YEAR 3 (n.d.), [https://www.publiccharters.org/sites/default/files/documents/2018-08/napcs\\_management\\_report\\_web%20New%20Final.pdf](https://www.publiccharters.org/sites/default/files/documents/2018-08/napcs_management_report_web%20New%20Final.pdf).

<sup>26</sup> Benjamin M. Teresa & Ryan M. Good, *Speculative Charter School Growth in the Case of UNO Charter School Network in Chicago*, 54 URBAN AFF. REV. 1107, 1112 (2018).

schools.<sup>27</sup> In the 2000s, major philanthropic foundations in the US dramatically increased funding to EMOs while proportionately decreasing funding to traditional public schools.<sup>28</sup> Specifically, recent evidence suggests that philanthropic foundations prefer to fund national-level advocacy and EMOs to stimulate charter school growth.<sup>29</sup> However, due to the decentralized nature of the US education system, foundations also direct significant funds to state and local levels.<sup>30</sup>

In addition to philanthropic organizations, the federal government has recently promoted the growth of EMOs through the Charter Schools Program (CSP), which allocates funding to expand the number of “high-quality” charter schools in the country.<sup>31</sup> In 2017, the federal government spent \$253 million pursuant to the CSP.<sup>32</sup> Of that amount, \$52 million went to a newly created EMO-expansion program titled “Grants to Charter Management Organizations for the Replication of High-Quality Charter Schools.”<sup>33</sup>

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<sup>27</sup> GARY MIRON & CHRISTOPHER SHANK, NEPC REVIEW: CHARTER MANAGEMENT ORGANIZATIONS 2017 (CREDO, JUNE 2017) 2 (Sep. 2017), [https://nepc.colorado.edu/sites/default/files/reviews/TTR%20Miron%20CMOs\\_2.pdf](https://nepc.colorado.edu/sites/default/files/reviews/TTR%20Miron%20CMOs_2.pdf).

<sup>28</sup> Joseph J. Ferrare & R. Renee Setari, *Converging on Choice: The Interstate Flow of Foundation Dollars to Charter School Organizations*, 47 EDUC. RSCHR. 34, 34 (2017).

<sup>29</sup> *Id.* at 35.

<sup>30</sup> *Id.*

<sup>31</sup> U.S. DEP’T EDUC., WELCOME TO ED’S CHARTER SCHOOLS PROGRAM (Oct. 16, 2015), <https://www2.ed.gov/about/offices/list/oii/csp/index.html>.

<sup>32</sup> U.S. DEP’T EDUC., U.S. DEPARTMENT OF EDUCATION AWARDS \$253 MILLION IN GRANTS TO EXPAND CHARTER SCHOOLS (Sep. 28, 2017), <https://www.ed.gov/news/press-releases/us-department-education-awards-253-million-grants-expand-charter-schools>.

<sup>33</sup> NAT’L ALL. PUB. CH. SCHS., NATIONAL ALLIANCE CONGRATULATES RECIPIENTS OF 2017 U.S. DEPARTMENT OF EDUCATION CHARTER SCHOOL PROGRAM GRANTS (Sep. 28, 2017), [https://info.publiccharters.org/2017-charter-schools-program-grants-announced?ecid=ACsprvsAIXN9g7JhzoZquGUbt7vhg8\\_qtrjBOOLxhu3JfSKMBQX5Z-mjhH8qsdBHo1pLY6zNfC3kg&utm\\_source=hs\\_email&utm\\_medium=email&\\_hsenc=p2ANqtz-95MEMh60-wrUIyiqAS50ZLtwVRXEKMYACMPdlHBhrK9Hv2MmW9ad0dU\\_Mo8b1dKJN5YduORZHjl6xkV6licASXDDRMc0t5R\\_0VJcCbuvQ\\_jSv-8g](https://info.publiccharters.org/2017-charter-schools-program-grants-announced?ecid=ACsprvsAIXN9g7JhzoZquGUbt7vhg8_qtrjBOOLxhu3JfSKMBQX5Z-mjhH8qsdBHo1pLY6zNfC3kg&utm_source=hs_email&utm_medium=email&_hsenc=p2ANqtz-95MEMh60-wrUIyiqAS50ZLtwVRXEKMYACMPdlHBhrK9Hv2MmW9ad0dU_Mo8b1dKJN5YduORZHjl6xkV6licASXDDRMc0t5R_0VJcCbuvQ_jSv-8g).

## B. Academies

Academies were first introduced in 2000 as the City Academy Program.<sup>34</sup> City academies were to replace locally run schools in urban areas that were deemed to be failing by the school inspection body Ofsted, or that were underachieving.<sup>35</sup> The Education Act 2002 permitted academies to open outside of urban areas.<sup>36</sup>

Eight years later, Parliament enacted the Academies Act 2010.<sup>37</sup> This statute extended the academy option, until then limited to struggling schools, to include successful schools at both the primary and secondary levels.<sup>38</sup> The government financed conversion costs and provided considerable financial incentives to encourage schools to convert.<sup>39</sup> The number of academies increased dramatically as a result of these policy changes. In 2010, there were 203 academies throughout England, all of them serving secondary schools with high proportions of disadvantaged students.<sup>40</sup> As of September 2018, there were 8,177 academies, constituting 36% of England's state funded schools.<sup>41</sup> About 66% of England's secondary schools and 30% of its primary schools have achieved academy status.<sup>42</sup>

Academy trusts (ATs) run academies.<sup>43</sup> ATs are nonprofit private trusts that enter into funding agreements with the Secretary of State for Education.<sup>44</sup> Single academy trusts (SATs)

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<sup>34</sup> Ann West & Elizabeth Bailey, *The Development of the Academies Programme: 'Privatising' School-Based Education in England 1986-2013*, 61 BRIT. J. EDUC. STUD. 137, 143 (2013).

<sup>35</sup> *Id.* 144.

<sup>36</sup> *Id.* at 145.

<sup>37</sup> Academies Act, 2010, c. 32 (Eng.), <https://services.parliament.uk/Bills/2010-12/academieshl.html>.

<sup>38</sup> *Id.* § 3(1).

<sup>39</sup> HELEN F. LADD & EDWARD B. FISKE, ENGLAND CONFRONTS THE LIMITS OF SCHOOL AUTONOMY 6 (Working Paper 232) (Oct. 25, 2016), <https://ncspe.tc.columbia.edu/working-papers/OP232.pdf>; West & Bailey, *supra* note 34, at 139.

<sup>40</sup> *Id.*

<sup>41</sup> DEP'T FOR EDUC., OPEN ACADEMIES, FREE SCHOOLS, STUDIO SCHOOLS AND UTCs AND ACADEMY PROJECTS AWAITING APPROVAL: SEPTEMBER 2018 (Nov. 1, 2018), <https://www.gov.uk/government/publications/open-academies-and-academy-projects-in-development#history>.

<sup>42</sup> *Id.*

<sup>43</sup> DEP'T FOR EDUC., GOVERNANCE HANDBOOK 2017, *supra* note 3, at 43.

<sup>44</sup> *Id.*

run one academy and so have a single funding agreement with the Secretary.<sup>45</sup> Multi-academy trusts (MATs) run more than one academy and so have both a master funding agreement with the Secretary as well as supplemental funding agreements for each academy.<sup>46</sup>

The English government has supported the growth of MATs in order to encourage the rapid expansion of academies.<sup>47</sup> One strategy involved funding: “The more schools in [an MAT], the more funding available for its central offices.”<sup>48</sup> This funding strategy worked. In 2012, there were 312 MATs, which ran 39% of all academies.<sup>49</sup> By 2015, almost two-thirds of academies were in MATs, and 517 MATs had 2 to 5 academies, 98 had 6 to 15, and 19 MATs were responsible for 16 or more academies.<sup>50</sup> In 2017, MATs ran 73% of all academies.<sup>51</sup>

The role of MATs in academy expansion continues to be encouraged by the Department for Education (DfE), the governmental department responsible for education in England.<sup>52</sup> In 2016, the DfE, announced its full-throttled support for MATs in a white paper titled *Educational Excellence Everywhere*.<sup>53</sup> This paper called for the academization of all English schools by 2022.<sup>54</sup> Initially, the DfE intended this transition to be mandatory, but, following strong

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<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> LADD & FISKE, ENGLAND CONFRONTS THE LIMITS, *supra* note 39, at 6.

<sup>48</sup> *Id.*

<sup>49</sup> Melanie C.M. Ehren & David Godfrey, *External Accountability of Collaborative Arrangement; A Case Study of a Multi Academy Trust in England*, 29 EDUC. ASSESS. EVAL. & ACC. 339, 340 (2017).

<sup>50</sup> *Id.*

<sup>51</sup> ANNE WEST & DAVID WOLFE, ACADEMIES, THE SCHOOL SYSTEM IN ENGLAND AND A VISION FOR THE FUTURE 4 (June 2018), <http://www.lse.ac.uk/social-policy/Assets/Documents/PDF/Research-reports/Academies-Vision-Report.pdf>.

<sup>52</sup> DEP’T FOR EDUC., ABOUT US (n.d.), <https://www.gov.uk/government/organisations/department-for-education/about>.

<sup>53</sup> DEP’T FOR EDUC., EDUCATIONAL EXCELLENCE EVERYWHERE (Mar. 2016), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/508447/Educational\\_Excellence\\_Everywhere.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/508447/Educational_Excellence_Everywhere.pdf).

<sup>54</sup> *Id.* at 22.

resistance, the DfE modified its approach to strong encouragement.<sup>55</sup> The white paper declared that MATs were the mechanism for enabling the spread of academies because:

MATs are the only structures which formally bring together leadership, autonomy, funding, and accountability across a group of academies in an enduring way; and are the best long term formal arrangement for stronger schools to support the improvement of weaker schools.<sup>56</sup>

The DfE provided several rationales for declaring this belief. For instance, MATs would provide “improved opportunities and support from teachers” and “a broader curriculum and more opportunities for children.”<sup>57</sup> MATs would also help build infrastructure by “expanding the reach and influence of the most successful leaders” and “offer[ing] more senior roles and rapid progression opportunities” so that “the best leaders can play new, more influential roles across more schools.”<sup>58</sup> Moreover, the DFE claimed that MATs could expand into high need areas in a manner that the best local educational authorities never could.<sup>59</sup>

## **Section II: EMOs, ATs, and Related-Party Transactions and Examples of Abuse**

### **A. Charter Schools**

In the United States, there is no nationwide compilation of related-party transactions. However, the Grand Canyon Institute performed an analysis of related-party transactions in Arizona during the 2013-14 school year.<sup>60</sup> This study found that 77% of the state’s charter

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<sup>55</sup> Andrew Eyles *et al.*, *Academies 2 – The New Batch: The Changing Nature of Academy Schools in England*, 39 FISC. STUD. 121, 124 (2018).

<sup>56</sup> DEP’T FOR EDUC., EDUCATIONAL EXCELLENCE EVERYWHERE, *supra* note 53, at 57.

<sup>57</sup> *Id.* at 16.

<sup>58</sup> *Id.* at 14.

<sup>59</sup> *Id.* at 15.

<sup>60</sup> CURTIS CARDINE & DAVID WELLS, FOLLOWING THE MONEY: TWENTY YEARS OF CHARTER SCHOOL FINANCES IN ARIZONA (A META-ANALYSIS OF CHARTER SCHOOL FINANCIALS AND WHAT THEY TELL US) (Sep. 17, 2017), <http://grandcanyoninstitute.org/following-the-money-twenty-years-of-charter-school-finances-in-arizona/>.



schools had engaged in related-party transactions.<sup>61</sup> Many of these transactions were between nonprofit EMOs and for-profit related-parties, which called into question the nonprofit nature of these EMOs.<sup>62</sup> Furthermore, 48% of charter school expenditures for contracts, leases, and rents for that year were owed to for-profit related parties, totaling \$497.5 million.<sup>63</sup>

There have been many questionable related-party transactions involving real estate deals.<sup>64</sup> For example, a for-profit EMO named Charter Schools USA (CSUSA), which operates 49 charter schools in Florida, conducts its real estate deals through several affiliated businesses.<sup>65</sup> The facilities costs for CSUSA-managed schools were 32% of their budget – more than 13% of the national average for charter school facilities costs.<sup>66</sup>

The real estate deals between Imagine Schools, a non-profit EMO that operates more than 60 schools, and its for-profit affiliate, SchoolHouse Finance, are even more extreme. These charter schools can spend up to 40% on rent, which creates a tight budget for educational necessities, such as textbooks.<sup>67</sup> In *Renaissance Academy for Math & Science of Missouri v. Imagine Schools*, a federal judge ordered Imagine Schools to pay almost \$1 million to one of its

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<sup>61</sup> *Id.* at 11.

<sup>62</sup> *Id.* at 32.

<sup>63</sup> *Id.* at 6.

<sup>64</sup> See, e.g., Catherine Candisky, *Ohio Taxpayers Paid \$7.7 Million to Renovate Charter-School Building Valued at \$2.4 Million*, COLUMBIA DISPATCH (Jul. 30, 2018), <https://www.dispatch.com/news/20180729/ohio-taxpayers-paid-77-million-to-renovate-charter-school-building-valued-at-24-million>; IN THE PUB. INTEREST, ACADEMICA'S FLORIDA REAL ESTATE OPERATIONS (Jun. 2016), [https://www.inthepublicinterest.org/wp-content/uploads/ITPI\\_Academica\\_Florida\\_Research\\_Brief\\_June\\_2016.pdf](https://www.inthepublicinterest.org/wp-content/uploads/ITPI_Academica_Florida_Research_Brief_June_2016.pdf); Ronald Huefner & Marie Blouin, *Control Issues in Charter Schools: An Examination of New York State Comptroller's Audits*, CPA J. (Apr. 2018), <https://www.cpajournal.com/2018/04/30/control-issues-in-charter-schools/>; Jeremy Mohler, *Charter Schools Are a Hot Real Estate Market – and That's Bad for Students*, IN THE PUB. INTEREST (Oct. 18, 2018), <https://medium.com/in-the-public-interest/charter-schools-are-a-hot-real-estate-market-and-thats-bad-for-students-153fe8554bb4>; PIET VAN LIER, PUBLIC GOOD VS. PRIVATE PROFIT: IMAGINE SCHOOLS, INC. IN OHIO 3 (May 2010), <http://www.policymattersohio.org/wp-content/uploads/2011/09/ImagineSchools2010.pdf>.

<sup>65</sup> Pat Hall & Sue Legg, *The League in Action on For-Profit Charters*, Oct. 1, 2016, LWVEDUCATION, <http://lwveducation.com/the-league-in-action-on-for-profit-charters/>.

<sup>66</sup> *Id.*

<sup>67</sup> Tim Walker, *What the Charter School Industry Can Learn from Enron – Before It's Too Late*, NEATODAY, Mar. 31, 2017, <http://neatoday.org/2017/03/31/charter-schools-second-coming-of-enron/>.

former schools for charging it excessive rent.<sup>68</sup> The court’s ruling suggested that Imagine Schools was essentially taking advantage of the charter school: The EMO profited from the excessive rent and failed to tell the school’s board of directors how the cost might disrupt the school’s ability to pay for textbooks and teacher salaries.<sup>69</sup>

An audit conducted by the U.S. Department of Education’s Office of the Inspector General, the federal agency’s watchdog, provided further evidence of the emerging danger.<sup>70</sup> This audit, which assessed the risks posed by charter school EMOs to the Department’s objectives, examined 33 charter schools from six states: California, Florida, Michigan, New York, Pennsylvania, and Texas.<sup>71</sup> The OIG found 36 instances of internal control weaknesses – 13 of these instances involved related-party transactions.<sup>72</sup> These weaknesses were concerning because they increased the possibility of financial fraud and abuse, and they increased the risk that students would not receive services consistent with federal program objectives.<sup>73</sup>

## B. Academies

In contrast to charter schools, there are data regarding the scope of related-party transactions in the academy sector. These data show that related-party transactions are quite common. The Education Funding Agency (EFA), the agency responsible for academy oversight,

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<sup>68</sup> Findings of Fact and Conclusions of Law at 24-25, *Renaissance Acad. for Math & Sci. of Mo. v. Imagine Schs.*, No. 4:13-CV-00645-NKL (W.D. Mo. Dec. 18, 2014), <http://courtweb.pamd.uscourts.gov/courtwebsearch/mowd/YgEGzNViWt.pdf>.

<sup>69</sup> *Id.* at 18-19.

<sup>70</sup> U.S. DEP’T EDUC., OFF. INSPECT. GEN., NATIONWIDE ASSESSMENT OF CHARTER AND EDUCATION MANAGEMENT ORGANIZATIONS (Sep. 2016), <https://www2.ed.gov/about/offices/list/oig/auditreports/fy2016/a02m0012.pdf>.

<sup>71</sup> *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 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.* (inner quotations omitted). For consistency purposes, we use the term EMO to refer to the entities described in the audit.

<sup>72</sup> *Id.* at 40.

<sup>73</sup> *Id.* at 16.

found that 976 ATs – or 43% – had disclosed related-party transactions during the 2012-13 school year.<sup>74</sup> These transactions totaled £71 million.<sup>75</sup> In 2015-16, 1,055 ATs (40%) disclosed related-party transactions. These transactions increased to 3,033, totaling almost £121 million.<sup>76</sup> Moreover, ATs had entered into 70 related-party transactions, each of which exceeded £250,000.<sup>77</sup> These transactions amounted to almost £62 million.<sup>78</sup>

The EFA began to record the frequency of related-party transactions in the academy sector because of the irregularities involving the Durand Academy Trust.<sup>79</sup> This AT ran an early years center – comparable to pre-K – as well as a primary and secondary school.<sup>80</sup> Because of problems revealed in the AT's financial statements, the EFA investigated the trust's related-party transactions.<sup>81</sup> This investigation identified two particularly troubling arrangements. The first transaction was with a company owned by the executive head for the management of the AT's leisure and accommodation facilities.<sup>82</sup> This company received £790,000 for the management of

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<sup>74</sup> EDUC. FUND. AG'CY, REVIEW OF RELATED PARTY TRANSACTIONS IN ACADEMIES 3 (Nov. 2014), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/390210/EFA\\_review\\_of\\_related\\_party\\_transactions.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/390210/EFA_review_of_related_party_transactions.pdf). In 2017, the Education Funding Agency merged with the Skills Agency to become the Education and Skills Funding Agency (ESFA). JUSTINE GREENING, DEPARTMENT FOR EDUCATION AGENCIES: WRITTEN STATEMENT - HCWS559 (Mar. 28, 2017), <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2017-03-28/HCWS559/>.

<sup>75</sup> NAT'L AUDIT OFF., INVESTIGATION INTO THE EDUCATION FUNDING AGENCY'S OVERSIGHT OF RELATED PARTY TRANSACTIONS AT DURAND ACADEMY (Nov. 13, 2014), <https://www.nao.org.uk/report/investigation-into-the-education-funding-agencys-oversight-of-related-party-transactions-at-durand-academy/>.

<sup>76</sup> DEP'T FOR EDUC., ACADEMY SCHOOLS SECTOR IN ENGLAND (CONSOLIDATED ANNUAL REPORTS AND ACCOUNTS FOR THE YEAR ENDED 31 AUGUST 2016) 115, [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/654811/Academy\\_Schools\\_Sector\\_in\\_England\\_Consolidated\\_Annual\\_Report\\_and\\_Account....pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/654811/Academy_Schools_Sector_in_England_Consolidated_Annual_Report_and_Account....pdf).

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> Rajeev Syal, *Nearly Half of Academy Trusts Paid Millions to 'Dubious' Contracts*, THE GUARDIAN, Nov. 12, 2014, <https://www.theguardian.com/education/2014/nov/13/nearly-half-academy-trusts-related-party-transactions>.

<sup>80</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 7. Because of concerns over finances and conflicts of interests, the Department for Education terminated its funding agreement with the Durand Academy Trust in 2018. Freddie Whittaker, *Troubled Durand Academy Reopens as Van Gogh Primary, but Land Issues Continue*, SCHS. WK., Sep. 7, 2018, <https://schoolsweek.co.uk/troubled-durand-academy-reopens-as-van-gogh-primary-but-land-issues-continue/>.

<sup>81</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 5.

<sup>82</sup> *Id.* at 15.

these properties over a three-year period.<sup>83</sup> The second involved a contract for public relations and communications with a company owned by one of the trustees.<sup>84</sup> This company received £20,000 per month for its services.<sup>85</sup> The EFA ordered the trust to terminate its contract with its executive head's company.<sup>86</sup> With respect to the trustee's company, the EFA instructed the trust either to end the contract when it expired or conduct an open bidding process if the trust still needed the services.<sup>87</sup>

The related-party transactions involving the Wakefield City Academies Trust (WCAT) also garnered much media attention.<sup>88</sup> In 2015, this MAT, which sponsored 21 primary and secondary schools throughout Yorkshire, had received £10 million in funding from the DfE to set up "high-performing academy hubs in areas having some of the greatest need."<sup>89</sup> However, in the following year, the MAT came under scrutiny after it was revealed that it paid £440,000 to companies owned by the CEO and his daughter.<sup>90</sup> The MAT declared in a statement that the contracts were appropriate because they had been put out to bid.<sup>91</sup> However, a leaked DfE report identified 16 breaches of academy finance rules committed by WCAT, including the trust paying

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<sup>83</sup> *Id.* at 12.

<sup>84</sup> *Id.* at 16.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* at 21.

<sup>87</sup> *Id.*

<sup>88</sup> See, e.g., Rebecca Akrofile, *Academy Chain Comes under Fire for Financial Conflicts of Interest*, THE EDUCATOR, Oct. 26, 2016, <https://www.theeducator.com/news/academy-chain-comes-fire-financial-conflicts-interest/>; Will Hazell, *Wakefield City Academy Trust Paid £83K to Former CEO's Firm*, TES, Jan. 30, 2018, <https://www.tes.com/news/wakefield-city-academies-trust-paid-ps83k-former-ceos-firm>; John Roberts & Don Mort, Sonia Sodha, *The Great Academy Schools Scandal, Yorkshire Academy Chain Defends Spending More Than £300,000 on IT Deal with Firm Run by Its Own Boss*, YORKSHIRE POST, Oct. 24, 2016, <https://www.yorkshirepost.co.uk/news/education/yorkshire-academy-chain-defends-spending-more-than-300-000-on-it-deal-with-firm-run-by-its-own-boss-1-8196191>; THE GUARDIAN, Jul. 22, 2018, <https://www.theguardian.com/education/2018/jul/22/academy-schools-scandal-failing-trusts>;

<sup>89</sup> DEP'T FOR EDUC., & THE RT HON. NICKY MORGAN, SPEECH: NICKY MORGAN: ONE NATION EDUCATION (Nov. 3, 2015), <https://www.gov.uk/government/speeches/nicky-morgan-one-nation-education>.

<sup>90</sup> Eleanor Busby, *Academy Chain Spends £440,000 on Deals with Firms Run by CEO and His Daughter*, TES, Oct. 24, 2016, <https://www.tes.com/news/academy-chain-spends-ps440000-deals-firms-run-ceo-and-his-daughter>.

<sup>91</sup> *Id.*

the CEO £82,000 for less than 15 weeks of work.<sup>92</sup> This lack of governance and financial management put WCAT “in an extremely vulnerable position.”<sup>93</sup> In September 2017, WCAT declared that it was dissolving and ceasing the operation of its academy schools.<sup>94</sup>

Parliament has expressed concerns about the EFA’s ability to police related-party transactions in the academy sector. For instance, in a 2014 report, the House of Commons Committee of Public Accounts expressed that the “Agency might not know the true extent of related-party transactions in all education providers – even if it implements sophisticated monitoring systems – in the same manner that the accountability system in local authority settings might identify these transactions.”<sup>95</sup> Similarly, a report commissioned by the Education Select Committee, published in the same year, concluded that “the checks and balances on academy trusts in relation to conflicts of interest are still too weak.”<sup>96</sup>

Despite these concerns, the EFA has refused to outlaw related-party transactions.<sup>97</sup> Instead, the agency has identified a number of benefits to these business deals. For instance, the EFA has asserted that related-party transactions can reduce costs through economies of scale.<sup>98</sup> Specifically, the AT can achieve economies of scale by sharing services, such as facilities

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<sup>92</sup> Eleanor Busby, *Exclusive: ‘Extreme’ DfE Concern over Academy Trust that Paid CEO £82K for 15 Weeks’ Work*, TES, Nov. 4, 2016, <https://www.tes.com/news/exclusive-extreme-dfe-concern-over-academy-trust-paid-ceo-ps82k-15-weeks-work>.

<sup>93</sup> *Id.*

<sup>94</sup> Press Ass’n, *Failing Academy Trust to Pull out of 21 Schools*, THE GUARDIAN, Sep. 9, 2017, <https://www.theguardian.com/education/2017/sep/09/failing-academy-trust-to-pull-out-of-21-schools>.

<sup>95</sup> HOUSE OF COMMONS COMMTE. PUB. ACCTS., EDUCATION FUNDING AGENCY AND DEPARTMENT FOR EDUCATION FINANCIAL STATEMENTS (SIXTY-FIRST REPORT OF SESSION 2013-14) 13 (May 12, 2014), <https://publications.parliament.uk/pa/cm201314/cmselect/cmpublic/1063/1063.pdf>.

<sup>96</sup> TOBY GREANY & JEAN SCOTT, CONFLICTS OF INTEREST IN ACADEMY SPONSORSHIP ARRANGEMENTS: A REPORT FOR THE EDUCATION SELECT COMMITTEE 3 (Sep. 2014), <https://www.parliament.uk/documents/commons-committees/Education/Conflicts-of-interest-in-academies-report.pdf>.

<sup>97</sup> HOUSE OF COMMONS EDUC. COMMTE., ACADEMIES AND FREE SCHOOLS (FOURTH REPORT OF SESSION 2014-15) 46 (Jan. 21, 2015), <https://www.parliament.uk/documents/commons-committees/Education/report-education-academies-and-schools.pdf>.

<sup>98</sup> EDUC. FUND. AG’CY, REVIEW OF RELATED PARTY TRANSACTIONS IN ACADEMIES, *supra* note 74, at 21.

management services or catering or staffing.<sup>99</sup> ATs can also benefit from the “in-house” expertise – especially in situations where the “trust is related to a recognized national lead in a given area.”<sup>100</sup> It has also sought to improve the monitoring system of related-party transactions. We analyze these attempts in the following section.

### **Section III: Monitoring of Related-Party Transactions by Charter Schools and Academies<sup>101</sup>**

#### **A. Monitoring Systems for Related-Party Transactions in Charter Schools and Academies**

Governmental entities have implemented monitoring systems to protect against the abuse of related-party transactions in the charter-school and academy sectors. Table 1 provides a depiction of these monitoring systems in tabular form.

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<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> An earlier version of the U.S. charter-school monitoring system analysis appeared in Preston C. Green III, *et al.*, *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*, 93 IND. L. J. 1 (2018).

Table 1: Monitoring Systems for Related-Party Transactions for Charter Schools and Academies

	Charter Schools (States) <sup>102</sup>	Academies (National) <sup>103</sup>
Ensure that related-party transactions are properly documented and in the schools' best interest	External Auditors	External Auditors
Review related party contracts for possible conflict of interest	Charter School Boards	AT Boards
Provide fiscal oversight to protect against related party transactions	Charter Authorizers	Education and Skills Funding Agency (ESFA)
Investigate whistleblower allegations	Charter School Authorizers/State Regulatory Agencies	DfE, ESFA

An examination of the related-party transaction monitoring systems for EMOs and ATs reveals noteworthy similarities. First, each system employs external auditors who are charged with ensuring that all related-party transactions are properly documented.<sup>104</sup> Second, each monitoring system relies on governing boards that review related-party transactions for possible conflicts of interest. In the case of charter schools, the autonomous charter school boards that contract with the EMOs perform this function.<sup>105</sup> The ATs perform this role in the academy monitoring system.<sup>106</sup> Third, each monitoring system has entities that provide general fiscal oversight to protect against related-party transactions. In the case of charter schools, the charter authorizer plays that role.<sup>107</sup> The Education and Skills Funding Agency (ESFA), a departmental agency sponsored by the DfE,<sup>108</sup> performs this task for academies.<sup>109</sup> Finally, each system has an

<sup>102</sup> *Id.*

<sup>103</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 25.

<sup>104</sup> Green *et al.*, *supra* note 101, at 23-27; NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 25.

<sup>105</sup> Green *et al.*, *supra* note 101, at 31-34.

<sup>106</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 25.

<sup>107</sup> Green *et al.*, *supra* note 101, at 34-36.

<sup>108</sup> EDUC. & SKILLS FUND. AG'CY, ABOUT US (n.d.), <https://www.gov.uk/government/organisations/education-and-skills-funding-agency/about>.

<sup>109</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 25.

entity that investigates allegations made by whistleblowers. In the charter school systems, charter school authorizers, state auditors, and state departments of education are responsible for these investigations.<sup>110</sup> The ESFA and DfE perform this role with respect to academies.<sup>111</sup>

It is also important to note that in the case of charter schools, the federal government has not played a prominent role in the policing of related-party transactions. The federal government has spent more than \$4 billion since 1995 to encourage the growth of charter schools without emphasizing oversight.<sup>112</sup> The OIG signaled that it would take a more involved role in policing related-party transactions in its 2016 audit. In fact, the report made several suggestions for improving oversight of related-party transactions, including improving the Department's monitoring of charter school-EMO relationships.<sup>113</sup> However, President Donald Trump, who came into office after this audit was published, has expressed general displeasure of federal regulations.<sup>114</sup> Moreover, his secretary of Education, Betsy DeVos, has also displayed antipathy toward federal regulations.<sup>115</sup> Therefore, we have not included the federal government as part of the charter-school, related-party-transaction monitoring system.

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<sup>110</sup> Green *et al.*, *supra* note 101, at 28-30.

<sup>111</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 25.

<sup>112</sup> Dustin Beilke, *New Grants Announced: ED Continues to Pour Millions into Charter School Black Hole*, CTR. FOR MEDIA & DEMOC. PRWATCH (Sep. 29, 2016), <http://www.prwatch.org/news/2016/09/13151/education-department-continues-pour-millions-tax-dollars-charter-school-blackhole>.

<sup>113</sup> U.S. DEP'T EDUC., OFF. INSPECT. GEN., *supra* note 70, at 30-31.

<sup>114</sup> Terry Jones, *Deregulation Nation: President Trump Cuts Regulation at Record Rate*, INVESTOR'S BUS. DAILY, Aug. 14, 2018, <https://www.investors.com/politics/commentary/deregulation-nation-president-trump-cuts-regulations-at-record-rate/>.

<sup>115</sup> See, e.g., David Whitman & Arne Duncan, *Betsy DeVos and Her Cone of Silence on For-Profit Colleges*, BROOKINGS, Oct. 17, 2018, <https://www.brookings.edu/research/betsy-devos-for-profit-colleges-education-america/>; Elissa Nadworthy, *DeVos to Make It Tougher for Defrauded Students to Seek Debt Relief*, NPRED, July 27, 2018, <https://www.npr.org/sections/ed/2018/07/27/633107206/devos-to-make-it-tougher-for-defrauded-students-to-seek-debt-relief>; Valerie Richardson, *DeVos Moves to Roll Back Regulations on Federal Aid to Religious Colleges*, WASH. TIMES, May 10, 2018, <https://www.washingtontimes.com/news/2018/may/10/devos-moves-roll-back-regulations-federal-aid-reli/>.



The remainder of this section analyzes the monitoring systems for protecting against the abuse of related-party transactions in the charter and academy sectors and makes suggestions for improvement.

## B. Auditors

### 1. Charter Schools

Most charter laws require charter schools to submit to annual financial audits that comply with statutory or regulatory standards.<sup>116</sup> Although state laws require auditors to be truly independent, there have been instances where auditors failed to detect problematic related-party transactions because they were under the control of the EMO.<sup>117</sup> Therefore, charter authorizers must take special care to guarantee that auditors are actually independent.

Researchers have also advised auditors of charter schools to scrutinize related-party transactions for evidence of abuse. As Marie Blouin and Ronald Huefner observe: “In addition to traditional public school audit issues, charter school audits also require consideration of the appropriateness and review of contracts and transactions with the sponsoring organization,” and “conflicts of interest by board members, especially if they have ties to the sponsoring organization.”<sup>118</sup> This focus would be consistent with the two main standards used by charter-school auditors: generally accepted auditing standards (GAAS), and generally accepted

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<sup>116</sup> See, e.g., ALA. CODE § 16-6F-6(g)(5) (2018) (requiring audits to comply with generally accepted accounting principles); ARK. CODE ANN. § 6-23-505 (Wet 2018) (requiring audits to comply with generally accepted auditing principles); CAL. EDUC. CODE § 47605(b)(5)(1) (West 2018) (requiring audits to comply with generally accepted accounting principles); COLO. REV. STAT. ANN. § 22-30.5-104(4)(a) (West 2018) (requiring audits to comply with state department of education requirements); DC CODE § 38.1802.04(c)(11)(B)(ix) (2018) (requiring audits to comply with standards issued by U.S. Comptroller General); HAW. REV. STAT. ANN. § 302D-32 (West 2018) (requiring audits to comply with standards set by authorizer and state department).

<sup>117</sup> See Green *et al.*, *supra* note 101, at 26 for examples.

<sup>118</sup> Ronald Huefner & Marie Blouin, *Control Issues in Charter Schools: An Examination of New York State's Comptroller's Audits*, CPA J. (Apr. 2018), <https://www.cpajournal.com/2018/04/30/control-issues-in-charter-schools/>.

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>119</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>120</sup> SAS 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>121</sup>

Established by the U.S. Government Accountability Office (GAO), GAGAS sets the standards for auditors of governmental entities.<sup>122</sup> GAGAS requires auditors to identify any “laws, regulations, contracts or grant agreements that are significant within the context of the audit objectives.”<sup>123</sup> This consideration requires auditors to design auditing procedures “to obtain reasonable assurance of detecting instances of noncompliance.”<sup>124</sup>

## 2. Academies

The *Academies Financial Handbook*, which sets out the guidelines for the financial management of ATs, requires these entities to appoint an auditor to “certify whether their annual

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<sup>119</sup> AM. INST. CERT. PUB. ACCOUNT., AU SECTION 110: RESPONSIBILITIES AND FUNCTIONS OF THE INDEPENDENT AUDITOR 1593, 1593 (Nov. 1972), <https://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00110.pdf>.

<sup>120</sup> AM. INST. CERT. PUB. ACCOUNT., AU SECTION 316: CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, 1719, 1724, <https://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00316.pdf>.

<sup>121</sup> AM. INST. CERT. PUB. ACCOUNT., AU SECTION 314: UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT 1667, 1673, 1691-94 (Dec. 15, 2006).

<sup>122</sup> U.S. GOV'T ACCOUNT. OFF., GOVERNMENT AUDITING STANDARDS: 2011 REVISION (Dec. 2011), <http://gao.gov/assets/590/587281.pdf>.

<sup>123</sup> *Id.* at 140.

<sup>124</sup> *Id.*

accounts present a true and fair view of the trust's financial performance and position."<sup>125</sup> In 2013, the ESFA amended that *Handbook* to require ATs to pay no more than the costs of goods provided by related parties.<sup>126</sup> In 2014, the *Handbook* introduced a *de minimis* threshold of £2,500 on at-cost requirements that applied to related-party transactions. ATs had to pay no more than cost for any transaction above this limit.<sup>127</sup> The National Audit Office (NAO)<sup>128</sup> -- Parliament's auditing body<sup>129</sup> -- as well as Parliament<sup>130</sup> have expressed doubt that auditors can enforce the at cost policy. One concern is that it will be difficult for auditors to assess professional services, especially "where the academy is effectively buying in an expert's time and knowledge rather than goods with an historic cost."<sup>131</sup> Another problem that auditors face is that the at cost policy can be subject to manipulation.<sup>132</sup>

Instead of enforcing the at cost policy, we believe it would be wiser for auditors to develop protocols for identifying and scrutinizing particularly risky related-party transactions. This advice would be consistent with International Standard of Auditing 550 -- which academy auditors must follow<sup>133</sup> -- which governs related-party transactions.<sup>134</sup> As the standard explains, "an understanding of the entity's related party relations and transactions is relevant to the

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<sup>125</sup> EDUC. & SKILLS FUND. AG'CY, ACADEMIES FINANCIAL HANDBOOK 2018: FOR ACADEMY TRUSTEES, MEMBERS, ACCOUNTING OFFICERS, CHIEF FINANCIAL OFFICERS AND AUDITORS 36 (Sep. 1, 2018), <https://www.gov.uk/government/publications/academies-financial-handbook>.

<sup>126</sup> EDUC. FUND. AG'CY, ACADEMIES FINANCIAL HANDBOOK 2013: FOR ACADEMY TRUSTEES, ACCOUNTING OFFICERS, PRINCIPAL FINANCIAL OFFICERS AND AUDITORS 25 (Sep. 1, 2013), <https://www.gov.uk/government/publications/academies-financial-handbook-2013>.

<sup>127</sup> EDUC. FUND. AG'CY, ACADEMIES FINANCIAL HANDBOOK 2014: FOR ACADEMY TRUSTEES, ACCOUNTING OFFICERS, PRINCIPAL FINANCIAL OFFICERS AND AUDITORS 6 (Sep. 1, 2014), <https://www.gov.uk/government/publications/academies-financial-handbook-2014>.

<sup>128</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 6.

<sup>129</sup> NAT'L AUDIT OFF., ABOUT US (n.d.), <https://www.nao.org.uk/about-us/>.

<sup>130</sup> HOUSE OF COMMONS COMTE. PUB. ACCTS., ACADEMY SCHOOL'S FINANCES (THIRTIETH REPORT OF SESSION 1017-19) 10 (Mar. 30, 2018), <https://publications.parliament.uk/pa/cm201719/cmselect/cmpubacc/760/760.pdf>.

<sup>131</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 6.

<sup>132</sup> HOUSE OF COMMONS COMTE. PUB. ACCTS., *supra* note 127, at 5.

<sup>133</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 9.

<sup>134</sup> INT'L AUD. & ASSUR. STAND. BD., INT'L STAND. AUDIT. 550 503 (Dec. 15, 2009), <https://www.ifac.org/system/files/downloads/a029-2010-iaasb-handbook-isa-550.pdf>.

auditors' evaluation of whether one or more fraud risk factors are present ... because fraud may be committed through related parties.”<sup>135</sup>

We believe that auditors should pay particular attention to related-party transactions involving the senior executive leaders of ATs – these are principals for ATs<sup>136</sup> and chief executive officers for MATs.<sup>137</sup> According to the *Handbook*, these persons should serve as their trusts' accounting officers.<sup>138</sup> Accounting officers have a personal responsibility to Parliament and to the ESFA for the trusts' finances.<sup>139</sup> It is quite possible that senior executive leaders who are engaged in questionable related-party transactions might use their positions as accounting officers to cover their tracks.

## C. Charter School and AT Boards

### 1. Charter School Governing Boards

Charter school governing boards are legally responsible for ensuring the fiscal soundness of their schools.<sup>140</sup> However, charter school governing boards may be unprepared to fulfill this duty because they lack either the training or the independence to assess the related-party transactions of their EMO agents. In the *Renaissance Academy for Math & Science* case, for example, one board member testified at trial that he incorrectly believed that Imagine Schools had control over the board.<sup>141</sup> This testimony led the district court to describe the member as being “very confused” about his board duties.<sup>142</sup> The court also found that the governing board

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<sup>135</sup> *Id.* at 505-06.

<sup>136</sup> EDUC. & SKILLS FUND. AG'CY, ACADEMIES FINANCIAL HANDBOOK 2018, *supra* note 125, at 42.

<sup>137</sup> *Id.* at 41.

<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at 13.

<sup>140</sup> Preston C. Green, III, *et al.*, *Having It Both Ways: How Charter Schools Try to Obtain Funding of Private Schools and the Autonomy of Public Schools*, 63 EMORY L. J. 303, 304 (2013).

<sup>141</sup> *Renaissance Acad. For Math & Sci. of Mo.*, No 4:13-CV-00645-NKL, at 3.

<sup>142</sup> *Id.* at 4.

was subservient to Imagine Schools because the EMO had recruited the board members and had the board sign an operating agreement that allocated all tax revenues received by the board to the EMO.<sup>143</sup>

Charter school statutes should address the board training problem by ensuring that board members receive training with respect to their supervisory responsibilities. Indeed, 13 states require governing boards to receive training: Colorado,<sup>144</sup> Delaware,<sup>145</sup> Florida,<sup>146</sup> Georgia,<sup>147</sup> Massachusetts,<sup>148</sup> Minnesota,<sup>149</sup> Mississippi,<sup>150</sup> Nevada,<sup>151</sup> New Jersey,<sup>152</sup> New Mexico,<sup>153</sup> Tennessee,<sup>154</sup> Texas,<sup>155</sup> and Wisconsin.<sup>156</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>157</sup> Louisiana,<sup>158</sup> and South Carolina<sup>159</sup> – impose this requirement on their charter school governing boards.

Charter school laws should also guarantee that governing boards are structurally independent from EMOs. Nine states do provide this guarantee. These states are Colorado,<sup>160</sup>

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<sup>143</sup> *Id.*

<sup>144</sup> 1 COLO. CODE REGS. § 301-88:2.01(C) (West 2018).

<sup>145</sup> DEL. CODE ANN. tit. 14, § 1803 (West 2018).

<sup>146</sup> FLA. STAT. ANN. § 1022.33(9)(j)(4) (West 2018).

<sup>147</sup> GA. CODE ANN., § 20-2-2084(f) (West 2018).

<sup>148</sup> 603 MASS. CODE REGS. 1.06 (West 2018).

<sup>149</sup> MINN. STAT. ANN. § 124E.07(Subd. 7) (West 2018).

<sup>150</sup> 10-402 MISS. CODE REGS. § 2.5 (West 2018).

<sup>151</sup> NEV. REV. STAT. § 388A.246(20) (West 2018).

<sup>152</sup> N.J. ADMIN. CODE § 6A:32-3.2(a)(2) (West 2018).

<sup>153</sup> N.M. STAT. ANN. § 22-8B-5.1 (West 2018).

<sup>154</sup> TENN. CODE ANN. § 49-13-111(o) (West 2017).

<sup>155</sup> TEX. EDUC. CODE § 12.123 (West 2017).

<sup>156</sup> WIS. STAT. ANN. § 118.40 (2r)(2)(j) (West 2017); WIS. STAT. ANN. § 118.40 (2x)(2)(j) (West 2017).

<sup>157</sup> HAW. REV. STAT. § 302D-12(b)(3) (West 2018).

<sup>158</sup> LA. ADMIN. CODE tit. 28, pt. CXXXIX, § 2101(D)(2) (2018).

<sup>159</sup> S.C. STAT. § 59-40-50(B)(9) (2018).

<sup>160</sup> COLO. REV. STAT. § 22-30.5-104(4)(b) (West 2018).

Connecticut,<sup>161</sup> Illinois,<sup>162</sup> Indiana,<sup>163</sup> Maine,<sup>164</sup> Michigan,<sup>165</sup> Mississippi,<sup>166</sup> Nevada,<sup>167</sup> and Rhode Island.<sup>168</sup> Further, several of these states provide indicia for determining whether a charter school governing board is independent from its EMO:

1. The EMO must not select the members of the governing board;<sup>169</sup>
2. The governing board must select, retain, and compensate the attorney and auditing firm representing the board;<sup>170</sup>
3. The governing board and the EMO must reach the terms of the service contract through arms-length negotiations; and<sup>171</sup>
4. The EMO must not have control over financial decisions.<sup>172</sup>

Charter school board principals may also fail at assessing the related-party transactions of EMOs because board members have related-party transactions with the charter schools for which they are responsible. Initially, such business arrangements may not seem problematic because typically under nonprofit corporations law members of these boards can recuse themselves from decisions to enter into business arrangements with their companies. However, one wonders whether charter school boards can carry out their fiduciary duties with respect to the EMO if they also have business arrangements with the charter school. Might they be so distracted by their own financial interests that they fail to police the behavior of the EMO?

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<sup>161</sup> CONN. GEN. STAT. ANN. § 10-66tt(e) (West 2018).

<sup>162</sup> 105 ILL. COMP. STAT. §5/27A-10.5(e) (West 2018).

<sup>163</sup> IND. CODE ANN; § 20-24-3-2.5(4) (West 2018).

<sup>164</sup> 05-071 ME. CODE R. Ch. 140, § 2(8) (West 2018).

<sup>165</sup> MICH. COMP. LAWS ANN. § 380.507(1)(f) (West 2018).

<sup>166</sup> 10-402 MISS. CODE R. § 1.12(D) (West 2018).

<sup>167</sup> NEV. REV. STAT. § 388A.393(1)(a) (West 2018).

<sup>168</sup> R.I. Reg. Text 496815 (West 2018).

<sup>169</sup> 05-071 ME. CODE R. Ch. 140, § 2(8)(A) (West 2018).

<sup>170</sup> CONN. GEN. STAT. ANN. § 10-66tt(e); 05-071 ME. CODE R. Ch. 140, § 2(8)(B); R.I. Reg. Text 496815.

<sup>171</sup> 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).

<sup>172</sup> NEV. REV. STAT. § 388A.393(1)(a).

The predicament of PA Cyber Charter School (PA Cyber) illustrates this concern. At its peak, PA Cyber had an enrollment of more than 11,000 students across the state.<sup>173</sup> An audit conducted by the state auditor general revealed that the charter school paid the EMO that provided curriculum and management services to the schools more than \$153 million from 2011 to 2014, which amounted to nearly half of the school's annual budget.<sup>174</sup> The auditing office was especially 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 the EMO would receive 12 percent of the charter school's revenues received from the state and enrolling school districts.<sup>175</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>176</sup> The auditing office also found that board members had related-party transactions that compromised their ability to provide oversight over the management company. For instance, a board member's son was a director of operations for the EMO.<sup>177</sup> Another board member was a co-owner of a computer equipment company that was paid \$1.1 million from the charter school.<sup>178</sup>

The state auditor general expressed displeasure 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>179</sup> One of the solutions that the auditor general suggested to fix this problem was to

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<sup>173</sup> *Trombetta Pleads Guilty*, MORNING J., Aug. 25, 2016, <http://www.morningjournalnews.com/news/local-news/2016/08/trombetta-pleads-guilty/>.

<sup>174</sup> PA. DEP'T AUDIT. GEN., PERFORMANCE AUDIT: PENNSYLVANIA CYBER CHARTER SCHOOL 28 (Sep. 2016), <http://www.paauditor.gov/Media/Default/Reports/PACyberCharterSchool,%20Beaver,%20092116.pdf>.

<sup>175</sup> *Id.* at 29.

<sup>176</sup> *Id.*

<sup>177</sup> *Id.* at 19.

<sup>178</sup> *Id.* at 21.

<sup>179</sup> *Id.*

make charter school boards publicly elected.<sup>180</sup> It is doubtful whether this amendment would counter the specific oversight problem that occurred in the case of PA Cyber: i.e., board members who might have failed to provide oversight over the EMO because they too were benefiting from related-party transactions with the charter school. Rather, legislatures should consider prohibiting board members from engaging in related-party transactions with the charter schools for which they are responsible. Indeed, two states – Minnesota<sup>181</sup> and New Mexico<sup>182</sup> – have addressed this concern by prohibiting 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.

## 2. Academies

AT governing boards have the responsibility of “ensuring resources are allocated to strategic priorities and safeguarding the highest standards of highest priority” – this responsibility encompasses related-party transactions.<sup>183</sup> The *Handbook* commands boards to meet this duty by ensuring that “requirements for managing related party transactions are applied across the trust” and “manag[ing] personal relationships with related parties to avoid real and perceived conflicts of interest.”<sup>184</sup>

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<sup>180</sup> 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 (Sep. 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>.

<sup>181</sup> MINN. STAT. ANN. § 124E.07(subdiv. 3)(a) (West 2018).

<sup>182</sup> N.M. STAT. ANN. § 22-8B-5.2(A) (West 2018).

<sup>183</sup> DEP’T FOR EDUC., GOVERNANCE HANDBOOK 2017, *supra* note 3, at 4.

<sup>184</sup> EDUC. & SKILLS FUND, AG’CY, ACADEMIES FINANCIAL HANDBOOK 2018, *supra* note 125, at 30.



There have been a number of instances in which trustees of MATs have benefited from questionable related-party transactions between the MATs and the businesses that they run.<sup>185</sup> The Bright Tribe Multi-Academy Trust is an egregious example. This MAT, which ran 10 academy schools, paid companies owned by its director £3.9 million in 2016 and £681,000 in 2017.<sup>186</sup> A governmental investigation of the MAT revealed that 80% of its governors had engaged in related-party transactions.<sup>187</sup> Arrangements such as this one raise doubts as to whether board members are fulfilling their responsibility to protect the financial interests of their MATs.

The *Handbook* further advises trustees to refer to the guidance provided by the Charity Commission,<sup>188</sup> the regulatory body for all charities in England and Wales.<sup>189</sup> The Charity Commission's document titled *The Essential Trustee: What You Need to Know, What You Need to Do* provides that the actions a board takes with respect to related-party transactions depends "on the circumstances and the seriousness of the conflict of interest."<sup>190</sup> Generally, the affected trustee should be absent from any part of the meeting where the issue is being discussed.<sup>191</sup> The affected trustee should withdraw from any decision making on that issue.<sup>192</sup>

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<sup>185</sup> See, e.g., John Dickens, *Revealed: The 23 Trusts that Broke Rules over £4M Related-Party Transactions*, SChS. WK., Feb. 3, 2017, <https://schoolsweek.co.uk/revealed-the-23-trusts-that-broke-rules-over-4m-related-party-transactions/>; Jonathan Owen, *Exclusive: Former Academy Trustee's Firm Billed More than £6M in 'Related-Party' Payments*, TES, Nov. 7, 2017, <https://www.tes.com/news/exclusive-former-academy-trustees-firm-billed-more-ps6m-related-party-payments>.

<sup>186</sup> Helen Ward, *Exclusive: Bright Tribe Pays £680K in Related-Party Transactions*, TES, Jan. 31, 2018, <https://www.tes.com/news/exclusive-bright-tribe-pays-ps680k-related-party-transactions>.

<sup>187</sup> Pippa Allen-Kinros, *Embattled Bright Tribe Academy Trust to Close*, SChS. WK., Jul. 16, 2018, <https://schoolsweek.co.uk/embattled-bright-tribe-academy-trust-to-close/>.

<sup>188</sup> *Id.* at 10.

<sup>189</sup> CHARITY COMM'N FOR ENGLAND & WALES, ABOUT US (n.d.), <https://www.gov.uk/government/organisations/charity-commission/about>.

<sup>190</sup> CHARITY COMM'N FOR ENGLAND & WALES, THE ESSENTIAL TRUSTEE: WHAT YOU NEED TO KNOW, WHAT YOU NEED TO DO 18 (May 3, 2018), <https://www.gov.uk/government/publications/the-essential-trustee-what-you-need-to-know-cc3/the-essential-trustee-what-you-need-to-know-what-you-need-to-do>.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.*

However, Gillian Allcroft, the Deputy Chief Executive of the National Governance Association (NGA) – an independent charity that seeks to increase the effectiveness of AT governing boards<sup>193</sup> – doubts whether this approach is sufficient in situations that “involve significant financial transactions and family ties.”<sup>194</sup> As she explains (from the perspective of an AT board):

If you award a firm closely associated with a trustee a contract will you genuinely be able to demonstrate that you weren't influenced by her/his status?...The truth is regardless of how stringent you have been with your processes the perception that the trustee has benefited will linger. Alternatively, you may unconsciously look for reasons not to award the trustee's firm the contract to avoid such a charge – but they have may have been the best provider. Neither outcome is satisfactory. Better not to put oneself in that position in the first place.<sup>195</sup>

The guidance provided by the Charity Commission lends some support to Allcroft's skepticism. For example, *The Essential Trustee* advises that in cases involving serious conflicts, the company should take one of the following actions: (1) obtain permission from the Commission; (2) refrain from going forward with the conflict; or (3) require the trustee to resign.<sup>196</sup> Similarly, the Commission's document titled *Conflicts of Interest: A Guide for Charity Trustees* provides that in situations involving serious conflict of interest, charity boards should remove the conflict by: (1) “not pursuing the course of action”; (2) “proceeding in a different way so that the conflict of interest does not arise”; or (3) “not appointing a particular trustee or securing a trustee resignation.”<sup>197</sup>

As noted above, in the United States charter-school context, two states have found that related-party transactions between board members or their immediate families are so serious that

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<sup>193</sup> NAT'L GOV. ASS'N., WELCOME TO THE NATIONAL GOVERNANCE ASSOCIATION (n.d.), <https://www.nga.org.uk/Home.aspx>.

<sup>194</sup> Gillian Allcroft, *Ethical Governance and Leadership*, 7 ACAD. MAG. 28 (Aut. 2017), <http://academymag.co.uk/>.

<sup>195</sup> *Id.*

<sup>196</sup> CHARITY COMM'N FOR ENGLAND & WALES, THE ESSENTIAL TRUSTEE, *supra* note 190.

<sup>197</sup> CHARITY COMM'N FOR ENGLAND & WALES, CONFLICTS OF INTEREST: A GUIDE FOR CHARITY TRUSTEES 5 (May 1, 2014), <https://www.gov.uk/government/publications/conflicts-of-interest-a-guide-for-charity-trustees-cc29>.

they cannot be resolved by having the affected members absent themselves from discussions and excuse themselves from deliberations. Instead, these states have banned such persons from serving on charter school governing boards. Given the concerns raised about related-party transactions compromising the ability of AT boards to act as fiscal stewards, Parliament might consider imposing a similar ban.

One might ask why we would call for Parliament to consider banning related-party transactions for AT board members, but not call for a similar ban on the AT's senior executives. We respond by acknowledging that related-party transactions can provide opportunities for ATs to obtain economies of scale and in-house expertise.<sup>198</sup> But we also recognize that a core function of AT boards is “to oversee financial performance and make sure money is well spent.”<sup>199</sup> If evidence suggests that related-party transactions are compromising the ability of boards to carry out this duty, then a ban would be appropriate.

## C. Authorizers & ESFA

### 1. Charter Schools

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>200</sup> Charter school authorizers are “ultimately responsible for the fiscal oversight of each

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<sup>198</sup> EDUC. FUND. AG'CY, REVIEW OF RELATED PARTY TRANSACTIONS IN ACADEMIES, *supra* note 74, at 21.

<sup>199</sup> DEP'T FOR EDUC., GOVERNANCE HANDBOOK 2017, *supra* note 3, at 25.

<sup>200</sup> Sandra Vergari, *Charter School Authorizers: Public Agents for Holding Charter Schools Accountable*, 33 EDUC. & URB. SOC. 129, 132 (2001).

charter school they oversee.”<sup>201</sup> Their duty to ensure the fiscal health of charter schools extends “from application approval to oversight and monitoring to closure or renewal.”<sup>202</sup>

Consequently, authorizers play a pivotal role in guarding against unreasonable related-party transactions between EMOs and for-profit related parties. However, only two states – California and Connecticut – explicitly empower authorizers to review and approve these business arrangements. California’s law will go into effect on July 1, 2019.<sup>203</sup> On that date, the law stipulates that petitions for charter school applications, renewals or material revisions “shall not operate as, or be operated by ... a for-profit educational management organization.”<sup>204</sup> The law defines the term “operate as, or be operated by” to encompass the day-to-day management of a charter school.<sup>205</sup> The statute forbids charter schools from entering into subcontracts “to avoid the requirements of this paragraph.”<sup>206</sup> Consequently, this law appears to prevent nonprofit EMOs from contracting out to for-profit related-parties for day-to-day operations.<sup>207</sup> Connecticut’s administrative code places a number of limitations on related-party transactions.

These transactions are permissible under the following conditions:

[T]he costs incurred are (1) limited to the actual cost of goods or services; (2) applicable, appropriate and necessary to the transaction; and (3) do not exceed the fair market rate or value that a prudent person in a non-related party transaction would incur under the circumstances prevailing at the time.<sup>208</sup>

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<sup>201</sup> NAT’L CHARTER SCH. RESOURCE 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).

<sup>202</sup> *Id.*

<sup>203</sup> CAL. EDUC. CODE § 47604(b)(1) (2018).

<sup>204</sup> *Id.*

<sup>205</sup> *Id.* § (2)(A)(iii).

<sup>206</sup> *Id.* § (2)(B).

<sup>207</sup> Derek Black, *California Strikes Major Blow for Non-Profit Charter Schools*, EDUC. L. PROF. BLOG, Sep. 10, 2018, [https://lawprofessors.typepad.com/education\\_law/2018/09/california-strikes-major-blow-to-for-profit-charter-schools.html](https://lawprofessors.typepad.com/education_law/2018/09/california-strikes-major-blow-to-for-profit-charter-schools.html).

<sup>208</sup> *See* Section II(A)(1).

We have two concerns with California’s approach. First, we oppose the idea of banning related-party transactions involving for-profit entities. Although we are concerned with the abuse of these types of contractual arrangements, we cannot rule out the possibility that in some instances a related-party transaction might constitute the best deal for the charter school. Second, we find it troubling that California’s provision addresses only contracts that deal with day-to-day management. Thus, this language may fail to address other potential areas of abuse, such as real estate.<sup>209</sup> Instead, the bill provides that these business agreements fall under the responsibility of charter school boards. As we have explained above, states should provide boards with training that addresses related-party transactions so that they can be up to this task.

By contrast, Connecticut’s regulations provide better guidance for its authorizer, the state department of education. By instructing the department to examine the appropriateness and necessity of the related-party transaction and to ensure that each transaction does not exceed fair market value, the regulations call for the authorizer to guard against abuse while allowing for the possibility that the transaction might provide the best goods or services to the charter school. However, we advise other states to be wary of adopting Connecticut’s at-cost requirement because of the concerns raised with respect to academies.<sup>210</sup>

## 2. Academies

The ESFA is responsible for providing financial oversight over academy schools.<sup>211</sup> This responsibility includes related-party transactions.<sup>212</sup> In 2013, the *Handbook* required academy

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<sup>209</sup> See Section III(B)(1).

<sup>210</sup> See Section III(B)(2).

<sup>211</sup> Sally Weale, *MPs Criticise Failure to Tackle Excessive Salaries in Academies*, THE GUARDIAN (Mar. 30, 2018), <https://www.theguardian.com/education/2018/mar/30/mps-criticise-government-oversight-of-academy-school-finances>.

<sup>212</sup> NATIONAL AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 25.

trusts (ATs) to obtain approval for related-party transactions that were “novel” or “contentious.”<sup>213</sup> Novel transactions “are those in which the academy trust has no experience, or are outside the range of normal business activity for the trust.”<sup>214</sup> Contentious transactions are “those which might give rise to criticism of the trust by the public or the media.”<sup>215</sup> In 2017, the *Handbook* was amended to include “repercussive” transactions – “those which are likely to cause pressure on other trusts to take a similar approach and hence have wide financial implications.”<sup>216</sup>

The House of Commons expressed dissatisfaction with this line of review, noting that “[i]n practice this means that the majority of day-to-day related party transactions require no prior approval.”<sup>217</sup> Indeed, this legislative body expressed the concern that the ESFA only became aware of most related-party transactions when it reviewed the annual accounts.<sup>218</sup> To prevent the abuse of related-party transactions, the House of Commons recommended that the ESFA amend the *Handbook* to prohibit ATs from entering into related-party transactions without the agency’s approval.<sup>219</sup> The ESFA did not adopt the House of Commons’ blanket recommendation to approve all related-party transactions – probably because of the sheer size of the academy sector. However, the agency did decide to impose a requirement, starting in April 2019, that ATs must obtain prior approval from the ESFA for contracts with a related party if a

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<sup>213</sup> EDUCATION FUND. AGENCY, ACADEMIES FINANCIAL HANDBOOK 2013, *supra note* 123, at 22-23.

<sup>214</sup> *Id.* at 22.

<sup>215</sup> *Id.* at 23.

<sup>216</sup> EDUCATION & SKILLS FUND. AGENCY, ACADEMIES FINANCIAL HANDBOOK 2017: FOR ACADEMY MEMBERS, TRUSTEES, ACCOUNTING OFFICERS, CHIEF FINANCIAL OFFICERS AND AUDITORS 30 (Jul. 2017), <https://www.gov.uk/government/publications/academies-financial-handbook>.

<sup>217</sup> HOUSE OF COMMONS COMMITTEE OF PUB. ACCOUNTS, ACADEMY SCHOOL’S FINANCES: THIRTIETH REPORT OF SESSION 2017-19 5 (Mar. 30, 2018), <https://publications.parliament.uk/pa/cm201719/cmselect/cmpubacc/760/760.pdf>.

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*

single contract, or the sum of all contracts with that party in the same financial year exceed £20,000.<sup>220</sup>

The ESFA £20,000-threshold requirement for targeting related-party transactions is an improvement over the agency's policy requiring the review of novel, contentious, or repercussive transactions. First, the monetary threshold policy will actually trigger a review of related-party transactions in a way that the prior policy did not. Second, by setting a monetary threshold before conducting a review of the transactions between an AT and a related party, the ESFA has taken steps to avoid being overextended.

#### D. Charter School Authorizers/State Level Auditor & ESFA

##### 1. Charter Schools

Charter school monitoring systems authorize regulatory agencies, including state departments of education and state auditors, to conduct investigations when they receive notice of possible abuses of relate-party transactions.<sup>221</sup> These entities rely heavily on whistleblowers to provide them with information.<sup>222</sup> Therefore, state legislatures should consider instituting approaches that would motivate whistleblowers to expose wasteful or fraudulent related-party transactions.

Two federal statutes show that state legislatures could encourage whistleblowers to come forward by offering them financial awards. The first statute is the False Claims Act (FCA),<sup>223</sup> which imposes liability on any person who “knowingly presents, or causes to be presented, a

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<sup>220</sup> EDUC. & SKILLS FUND. AG'CY, ACADEMIES FINANCIAL HANDBOOK 2018, *supra* note 125, at 31.

<sup>221</sup> Green, *et al.*, *supra* note 101 at 28-30.

<sup>222</sup> CTR. POP. DEMOC. *ET AL.*, RISKING PUBLIC MONEY: CALIFORNIA CHARTER SCHOOL FRAUD (Mar. 2015), <http://laschoolreport.com/wp-content/uploads/2015/03/Charter-Schools-California-Report-b1-3.pdf>.

<sup>223</sup> 31 U.S.C.A. §§ 3729-33 (West 2018).

false or fraudulent claim for payment or approval.”<sup>224</sup> The FCA encourages whistleblowers to bring civil actions, or *qui tam* lawsuits, on behalf of the federal government.<sup>225</sup> Whistleblowers can obtain a bounty ranging from 15% to 30% of the government’s recovery.<sup>226</sup>

The second statute is the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).<sup>227</sup> Enacted in response to the financial crisis of 2008, this statute seeks to prevent another economic meltdown by placing more stringent regulations on lenders and banks.<sup>228</sup>

Dodd-Frank also encourages whistleblowers to expose violations of U.S. securities laws through the establishment of a whistleblower incentive program.<sup>229</sup> Run by the Securities and Exchange Commission (SEC), the whistleblower program gives financial awards to whistleblowers for original information that leads to monetary sanctions in excess of \$1 million.<sup>230</sup> Whistleblower awards range from 10% to 30% of the sanction amount.<sup>231</sup>

Both the FCA<sup>232</sup> and Dodd-Frank<sup>233</sup> protect whistleblowers from retaliatory actions from their employers, such as discharge, demotion, suspension, threats, or harassments, or any other discrimination. These statutes also provide several remedies for whistleblowers including reinstatement, double back pay, litigation costs, and attorneys’ fees.<sup>234</sup>

The financial awards provided by the FCA and Dodd-Frank have enabled the federal government to recover a great deal of money. In 2017, the federal government recovered \$3.7

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<sup>224</sup> *Id.* § 3729(a)(1)(A).

<sup>225</sup> *Id.* § 3730(b)(1), (c).

<sup>226</sup> *Id.* § 3730(d).

<sup>227</sup> Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>228</sup> CTR. AM. PROG., THE IMPORTANCE OF DODD-FRANK, IN 6 CHARTS, <https://www.americanprogress.org/issues/economy/news/2017/03/27/429256/importance-dodd-frank-6-charts/>.

<sup>229</sup> 15 U.S.C.A. § 78u-6 (West 2018).

<sup>230</sup> *Id.* § (a)(1).

<sup>231</sup> *Id.* § (a)(6).

<sup>232</sup> 31 U.S.C.A. § 3730(h)(1).

<sup>233</sup> 78 U.S.C.A. § (h)(1)(A).

<sup>234</sup> 31 U.S.C.A. § 3730(h)(2) (FCA); 78 U.S.C.A. § (h)(1)(C) (Dodd-Frank)



billion in settlements and judgments pursuant to the False Claims Act; \$3.4 billion came from *qui tam* lawsuits.<sup>235</sup> The financial incentives of the federal False Claims Act have been so successful that more than 50% of states have enacted their own false claims acts.<sup>236</sup> Since 2011, the Dodd-Frank whistleblowing incentive program has led to the imposition of \$1.5 billion in monetary sanctions.<sup>237</sup>

Taking impetus from the FCA and Dodd-Frank, state legislatures should consider developing whistleblower incentive programs for their charter schools. Specifically, these programs would do the following: (1) provide financial awards to whistleblowers for coming forward with information that would lead to a successful recovery of public funds; and (2) protect whistleblowers from retaliatory employment actions by charter schools, EMOs, or their affiliates.

Charter school investigatory bodies should also target certain types of related-party transactions for periodic reviews. For example, evidence suggests that related-party transactions involving real estate poses a problem to the charter school sector.<sup>238</sup> To combat such abuse, investigatory bodies can periodically examine the real estate deals to which charter schools have entered.

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<sup>235</sup> DEP'T JUS., JUSTICE DEPARTMENT RECOVERS \$3.7 BILLION FROM FALSE CLAIMS ACT CASES IN FISCAL YEAR 2017 (Dec. 21, 2017), <https://www.justice.gov/opa/pr/justice-department-recovers-over-37-billion-false-claims-act-cases-fiscal-year-2017>.

<sup>236</sup> Marianne W. Nitsch, Note: *Fraud on the Classroom: Why State False Claims Acts Are Not the Solution to All Fraud on State and Local Governments*, 93 TEX. L. REV. 1009, 1010 (2015).

<sup>237</sup> Jason Zuckerman & Matt Stock, *One Billion Reasons Why the SEC Whistleblower Reward Program Is Effective*, FORBES, Jul. 18, 2017, <https://www.forbes.com/sites/realspin/2017/07/18/one-billion-reasons-why-the-sec-whistleblower-reward-program-is-effective/#4d32d3cf3009>.

<sup>238</sup> See Section II(A)(1).

## 2. Academies

The ESFA investigates financial irregularities in the academy sector including those involving related-party transactions. Similar to charter schools, the ESFA relies on whistleblower revelations.<sup>239</sup> In fact, a freedom of information request revealed that from 2013 to 2017, whistleblowers triggered 14 out of 15 investigations into academy finances.<sup>240</sup> Thus, we examine the incentives provided for whistleblowers to come forward with respect to AT whistleblowers.

The Public Interest Disclosure Act (PIDA) 1998<sup>241</sup> and the Enterprise and Regulatory Reform (ERRA) 2013<sup>242</sup> protect “workers” who make disclosures in the public interest from dismissal and detrimental treatment. To receive protection, workers must reasonably believe that they are making disclosures in the public interest.<sup>243</sup> Protected disclosures include criminal offenses, failure to comply with legal obligations, and the concealment of these actions.<sup>244</sup> Workers who believe they have suffered from retaliation may seek financial compensation from an employment tribunal.<sup>245</sup>

Neither the PIDA nor the ERRA includes a whistleblower incentive program similar to Dodd Frank or the FCA. After the passage of the ERRA, the U.K. government in 2013 initiated a call for evidence to determine whether to make other changes in its whistleblowing framework.<sup>246</sup> The call considered, *inter alia*, whether the U.K. should provide financial

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<sup>239</sup> NAT'L AUDIT OFF., DURAND ACADEMY, *supra* note 75, at 25.

<sup>240</sup> Jess Staufenberg, *Over 90% of Investigations into Academy Finances Are a Result of Whistleblowers*, SCHS. WK., Jul. 10, 2017, <https://schoolsweek.co.uk/over-90-of-investigations-into-academy-finances-are-a-result-of-whistleblowers/>.

<sup>241</sup> Pub. Int. Disc. Act, 1998, c. 23 (Eng.), <https://www.legislation.gov.uk/ukpga/1998/23/contents/enacted>.

<sup>242</sup> Ent. & Reg. Ref. Act, 2013, c. 24 (Eng.), <http://www.legislation.gov.uk/ukpga/2013/24/contents/enacted>.

<sup>243</sup> *Id.*, Part II, § 17.

<sup>244</sup> Pub. Int. Disc. Act, § 1.

<sup>245</sup> *Id.*, § 3.

<sup>246</sup> DEP'T BUS. INN. & SKILLS, THE WHISTLEBLOWING FRAMEWORK: CALL FOR EVIDENCE (Jul. 2013), <http://www.legislation.gov.uk/ukpga/2013/24/contents/enacted>.

incentives to whistleblowers.<sup>247</sup> A year later, the government issued a response rejecting the adoption of a financial incentives.<sup>248</sup> Although the government “remained unconvinced that the introduction of financial incentives would change the cultural landscape in a positive way,” it did allow that “in due course,” it would consider employing financial incentives “in specific organisations or in very specific types of cases.”<sup>249</sup> Given the number of questionable related-party transactions occurring within academy trusts, the government might consider adopting a whistleblower incentive program for this sector.

Furthermore, the ESFA should not wait for whistleblowers to provide information for investigations. We suggest that once an AT crosses the £20,000 threshold for transactions with a related company, which would require approval from the ESFA, the agency should conduct periodic reviews of that business relationship. In 2016, Sir Amyas Morse, the Auditor General of the NAO, provided support for this suggestion during a House of Commons’ Education Committee discussing the financial management of the DfE. Morse called for the DfE and the ESFA to develop a number of “leading indicators” that would cause the agency to investigate an AT. One example for further scrutiny involved situations where “there were a lot of apparent conflict of interest issues to be managed.”

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<sup>247</sup> *Id.* at 16.

<sup>248</sup> DEP’T BUS. INN. & SKILLS, WHISTLEBLOWING FRAMEWORK CALL FOR EVIDENCE: GOVERNMENT RESPONSE 25 (Jun. 2014), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/323399/bis-14-914-whistleblowing-framework-call-for-evidence-government-response.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/323399/bis-14-914-whistleblowing-framework-call-for-evidence-government-response.pdf).

<sup>249</sup> *Id.*

## **Conclusions**

Related-party transactions involving private companies and their for-profit affiliates have bedeviled both U.S. charter schools and England's academies. Using comparative legal research methodologies, this article has attempted to determine why the respective monitoring systems have had a difficult time regulating related-party transactions and offer suggestions for improvement. Because our review has found such remarkable similarities between the monitoring systems for charter schools and academies, it is unsurprising that the recommendations for improving these monitoring systems are so similar.