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# North Carolina Charter Schools' (Non-?) Compliance with State and Federal Nonprofit Law

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NORTH CAROLINA CHARTER SCHOOLS'  
(NON-?) COMPLIANCE WITH STATE AND  
FEDERAL NONPROFIT LAW\*

THOMAS A. KELLEY III\*\*

*In North Carolina, as in most jurisdictions across the country, state law requires that charter schools be governed by nonprofit corporations. This Article examines the governance practices of a select group of North Carolina charter-holding nonprofits and asks whether they are complying with state and federal nonprofit law. It scrutinizes with particular care a group of North Carolina charter-holding nonprofit corporations that have entered into comprehensive management agreements with for-profit educational management organizations, also known as EMOs. Based on an exhaustive analysis of the nonprofit corporations' board meeting minutes, contracts, financial reports, tax filings, and real estate records, this Article concludes that certain North Carolina charter-holding nonprofits have very likely violated nonprofit law by in essence handing the keys of the charter schools over to the for-profit EMOs, permitting them with minimal supervision or disclosure to convert public educational dollars into significant corporate profits. This Article calls for legal and regulatory reform to rein in abusive practices by for-profit EMOs and more effectively safeguard the public funds that North Carolina citizens have devoted to education.*

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## INTRODUCTION

### A. *Charter School Fault Lines*

Depending on whom you ask, charter schools are either saving or destroying public education in North Carolina and across the United States. If you believe proponents, charter schools are engines of educational innovation.<sup>1</sup> They are unhindered by state government’s education-related bureaucratic strictures,<sup>2</sup> so they have more flexibility to hire qualified teachers (and fire those who underperform) and experiment with pedagogical approaches.<sup>3</sup> As they innovate, charters produce new ideas and new methods that can be adopted by traditional public schools.<sup>4</sup> Crucially, charters provide enhanced school choice for North Carolina parents, which, according to proponents, is an unalloyed benefit.<sup>5</sup>

According to detractors, charter schools divert desperately needed resources from already underfunded traditional public

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1. See, e.g., *The Facts on Charter Schools*, PUB. SCH. FIRST NC, <http://www.publicschoolsfirstnc.org/wp-content/uploads/2013/09/12-15-14-The-Facts-on-Charter-Schools.pdf> (last modified Dec. 15, 2014) [hereinafter *The Facts on Charter Schools*].

2. See *id.* (stating that North Carolina charter schools are exempt from most regulations and statutes that apply to other public schools).

3. See Paul T. Hill, *Realizing Chartering’s Full Potential*, in *CHARTER SCHOOLS AGAINST THE ODDS* 179, 187 (Paul T. Hill ed., 2006) (advocating for fewer barriers to charter schools’ ability to “make innovative use of artists, scientists, mathematicians, and other masters of key subject matter”); Molly O’Brien, *Free at Last? Charter Schools and the “Deregulated” Curriculum*, 34 *AKRON L. REV.* 137, 154–55 (2000) (“Charter school reform advocates assert that charter schools, . . . freed from the reform-stifling politics of bureaucratic school districts and entrenched teacher organizations, will be better and more responsive schools. Deregulation is expected to produce flexibility and innovation.”).

4. See O’Brien, *supra* note 3, at 139 (“Many charter school laws explicitly exempt charter schools from most state laws and local regulations so that they are free to innovate, to become laboratories for school reform. The charter school is envisioned as an engine for system-wide reform and innovation.”); Pedro Noguera, *Why Don’t We Have Real Data on Charter Schools?*, *THE NATION* (Sept. 24, 2014), <http://www.thenation.com/article/181753/why-dont-we-have-real-data-charter-schools#> (arguing that early charter school proponents believed charter schools would “serve as a laboratory for innovations that would then be applied to public schools”).

5. *The Facts on Charter Schools*, *supra* note 1; see also Derek W. Black, *Charter Schools, Vouchers, and the Public Good*, 48 *WAKE FOREST L. REV.* 445, 449 (2013) (“[S]ome argue that the greatest public good occurs when everyone is pursuing individual good because maximizing individual good accrues to the benefit of the whole. Per this concept, the individual good does not sacrifice the public good but actually serves it.”).

schools.<sup>6</sup> Because, unlike traditional public schools, they are not required to pay for students' transportation to and from school, because they are not required to feed students once they are on campus, and because they are not required to accommodate children with special needs,<sup>7</sup> they tend to attract those from motivated, often higher-resourced families, leaving traditional public schools to grapple with the more challenging and expensive students.<sup>8</sup> Critics add that studies demonstrate that in spite of charters' operational flexibility, they perform no better than traditional public schools at the essential task of educating children.<sup>9</sup> Finally, opponents argue that

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6. *The Facts on Charter Schools*, *supra* note 1 (arguing that charters divert resources from traditional public schools); *see also* Black, *supra* note 5, at 469–75 (arguing a significant portion of traditional public schools have been underfunded for some time and that the rise of charter schools exacerbates that resource problem).

7. Lisa Lukasik, *Deconstructing a Decade of Charter School Funding: An Argument for Reform*, 90 N.C. L. REV. 1885, 1889 (2012); *see also* Letter from the N.C. Justice Ctr. to the N.C. State Bd. of Educ. (Aug. 30, 2012), [http://www.ncjustice.org/sites/default/files/M\\_Ellinwood%20Charter%20Applicant%20Letter%2008\\_30\\_12.pdf](http://www.ncjustice.org/sites/default/files/M_Ellinwood%20Charter%20Applicant%20Letter%2008_30_12.pdf) (discussing lack of transportation provided by charter schools as well as difficulties in serving children with special needs); *The Facts on Charter Schools*, *supra* note 1 (discussing concerns that charter schools will fail to meet students' educational needs).

8. *See* Lukasik, *supra* note 7, at 1889 (referring to the fear that North Carolina charter schools create a “two track system”); *see also* Jeffrey R. Henig, *Charter Inroads in Affluent Communities: Hype or Turning Point?*, in *HOPES, FEARS, AND REALITIES: A BALANCED LOOK AT AMERICAN CHARTER SCHOOLS IN 2012*, at 13 (Robin J. Lake ed., 2013) (maintaining that even charter schools serving nonaffluent minority communities had lower proportions of special education, non-English-speaking, and truly poor students and tended to “crop off” students who cost more to educate); Black, *supra* note 5, at 474 (arguing that studies clearly show that charter schools engage in “cropping,” or discouraging the enrollment of high-need students, which results in a higher burden for the nearby traditional public schools); Lisa Rab, *Getting Schooled: Charter Schools Are a Booming Business, and North Carolina Has Opened the Floodgates*, *CHARLOTTE MAG.* (Oct. 2012), <http://www.charlottemagazine.com/Charlotte-Magazine/October-2012/Getting-Schooled/> (noting that critics accuse charter schools of catering to wealthier, white children, excluding needier kids and referring to a 2007 University of Michigan study that concluded that high achievement scores among students in a group of charter schools merely reflected the fact that the students were of high socioeconomic status). *But see* Robin J. Lake, *Will the Charter Movement Rest on Its Laurels or Innovate and Expand*, in *HOPES, FEARS, AND REALITIES: A BALANCED LOOK AT AMERICAN CHARTER SCHOOLS IN 2012*, at 2 (arguing that concerns about charters focusing on white suburbs are unfounded because it is a sign that charter schools are becoming widely accepted by a broad cross section of the public); Noguera, *supra* note 4 (arguing that many charter schools accept only the least difficult and therefore least expensive students).

9. Lukasik, *supra* note 7, at 1889 (citing CTR. FOR RESEARCH ON EDUC. OUTCOMES, STANFORD UNIV., *MULTIPLE CHOICE: CHARTER SCHOOL PERFORMANCE IN 16 STATES*, at 6 (2009), [http://credo.stanford.edu/reports/MULTIPLE\\_CHOICE\\_CREDO.pdf](http://credo.stanford.edu/reports/MULTIPLE_CHOICE_CREDO.pdf)); *see also* Natalie Gomez-Velez, *Urban Public Education Reform: Governance, Accountability, Outsourcing*, 45 *URB. LAW.* 51, 91 (2013) (arguing that “current ‘business model’ reform efforts that rely on outsourcing and the use of high stakes tests for everything from student retention to teacher evaluation to school closure have failed to establish improvements in

the seamy underside of school choice is that charters are leading to the re-segregation of public schools as parents choose charter schools populated by people of similar ethnicity, faith, and socioeconomic status.<sup>10</sup>

The policy arguments—both pro and con—surrounding charter schools are often fraught with emotion.<sup>11</sup> After all, the well-being of North Carolina’s children and broader society are at stake. However, those heated policy arguments are not what this Article is about. Instead, it will focus on a heretofore unexamined but crucially important legal issue related to North Carolina charter schools<sup>12</sup>: whether they are complying with state and federal laws governing nonprofit charitable organizations.

In North Carolina, as in most other states with charter schools, the enabling legislation requires that the charters—the written agreements that spell out the obligations of school organizers and

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student achievement”); RICHARD BUDDIN, THE IMPACT OF CHARTER SCHOOLS ON PUBLIC AND PRIVATE SCHOOL ENROLLMENTS 6 (CATO Inst., Policy Analysis No. 707, 2012), available at <http://www.cato.org/publications/policy-analysis/impact-charter-schools-public-private-school-enrollments> (summarizing various studies that generally conclude that learning outcomes were no better at charter schools as compared to traditional public schools); LEAGUE OF WOMEN VOTERS OF FLA., STATEWIDE STUDY ON SCHOOL CHOICE AND CONSENSUS REPORT ON CHARTER SCHOOLS 12–13 (2014) (concluding, among other things, that Florida charter schools perform no better and tend to be more segregated than traditional public schools); Rab, *supra* note 8 (arguing it is a subject of great debate whether charter schools perform as well as traditional public schools and citing the Stanford study concluding that only seventeen percent of charter schools outperformed public schools).

10. See Henig, *supra* note 8, at 23 (arguing that charter school supporters generally admit that charter schools tend not to be diverse but defend them as often “targeting minority communities”); LEAGUE OF WOMEN VOTERS OF FLA., *supra* note 9, at 12 (concluding that charter schools in Florida have increased segregation); Black, *supra* note 5, at 465–66 (arguing that charter school and voucher programs permit parents to dissent against integration and pointing out that North Carolina’s Charlotte-Mecklenburg School District has in the last decade amassed the largest charter school population in the state in terms of percentage and also has become the most segregated district in the state); *Quick Facts: Charter Schools*, PUB. SCH. FIRST NC, <http://www.publicschoolsfirstnc.org/wp-content/uploads/2014/10/9-30-14-QUICK-FACTS-Charter-Schools.pdf> (last modified Sept. 30, 2014) (citing national studies and North Carolina-specific evidence showing that North Carolina charter schools tend to be racially isolated and disproportionately serve higher income students).

11. See Noguera, *supra* note 4 (claiming recent policy debates over charter schools are becoming “increasingly acrimonious”); see also O’Brien, *supra* note 3, at 137–38 (“[D]ecisions about the public school curriculum give rise to particularly heated conflicts and controversy.”).

12. See Black, *supra* note 5, at 446 (arguing that most of the discourse regarding charter schools and vouchers has been about whether they produce better educational outcomes); Susan L. DeJarnatt, *Follow the Money: Charter Schools and Financial Accountability*, 44 URB. LAW. 37, 41–42 (2012) (arguing that most charter school scholarship focuses on their educational utility).

grant them the formal right to create and maintain schools using public funds<sup>13</sup>—be held by charitable nonprofit corporations.<sup>14</sup> In most cases, those charitable corporations themselves take on the tasks of planning and running the new schools: developing learning goals and curricula, hiring and firing administrators and teachers, renting or purchasing facilities and equipment, and myriad other tasks.<sup>15</sup> In some cases, however, the nonprofit charter-holders turn most or all of the schools’ educational and administrative functions over to a separate nonprofit or for-profit company, variously referred to as a charter management organization (“CMO”) or educational management organization (“EMO”).<sup>16</sup> Often, such management organizations are regional or national in scope, managing numerous schools in a number of different states.<sup>17</sup> They claim to enhance public education by introducing innovative curricula and by more nimbly serving the educational needs of students and families.<sup>18</sup> They say not only that

13. See Julia L. Davis, *Contracts, Control and Charter Schools: The Success of Charter Schools Depends on Stronger Nonprofit Board Oversight to Preserve Independence and Prevent Domination by For-Profit Management Companies*, 2011 BYU EDUC. & L.J. 1, 6 (2011) (noting that a charter is a sort of contract that outlines the obligations of the school).

14. N.C. GEN. STAT. § 115C-218.1(a) (2014); see also Davis, *supra* note 13, at 7 (noting that only a few states allow for-profits to hold charters).

15. NAT’L ALLIANCE FOR PUB. CHARTER SCH., CMO AND EMO PUBLIC CHARTER SCHOOLS: A GROWING PHENOMENON IN THE CHARTER SCHOOL SECTOR, at 2 tbl.1, app. A (2014), available at [http://www.publiccharters.org/wp-content/uploads/2014/01/NAPCS-CMO-EMO-DASHBOARD-DETAILS\\_20111103T102812.pdf](http://www.publiccharters.org/wp-content/uploads/2014/01/NAPCS-CMO-EMO-DASHBOARD-DETAILS_20111103T102812.pdf) (stating that in the 2009–2010 school year, 71.3% of charter schools were “freestanding” or non-CMO/EMO; for the 2009–2010 school year, 93% of North Carolina charter schools were “freestanding” (89 out of 96 schools)).

16. The terms CMO and EMO are not employed consistently in charter school literature. Some commentators use them interchangeably to refer to any management organization, whether for-profit or nonprofit. Others employ the term CMO to refer to nonprofit management organizations and EMO to refer to for-profit management organizations. See, e.g., ANNENBERG INST. FOR SCH. REFORM, PUBLIC ACCOUNTABILITY FOR CHARTER SCHOOLS: STANDARDS AND POLICY RECOMMENDATIONS FOR EFFECTIVE OVERSIGHT 6 (2014), available at <http://annenberginstitute.org/sites/default/files/CharterAccountabilityStds.pdf> (defining CMO and EMO). In this Article, I will follow what appears to be the trend by referring to “management organizations” when I mean all such organizations, CMOs or nonprofit management organization when I mean nonprofits, and EMOs or for-profit management organization when I refer to for-profits.

17. See John E. Chubb, *Should Charter Schools Be a Cottage Industry?*, in CHARTER SCHOOLS AGAINST THE ODDS, *supra* note 3, at 127, 145 (“For the most part [for-profit EMOs] have concentrated geographically . . . . Yet, some organizations have chosen to set up shop in many states.”). In 2006, some for-profit CMOs were operating in up to eighteen states, with EMO’s representing an average of 20.1 schools and CMOs representing an average of 10.1 schools. *Id.* at 146.

18. See BRYAN C. HASSEL, THE CHARTER SCHOOL CHALLENGE: AVOIDING THE PITFALLS, FULFILLING THE PROMISE 131–32 (1999) (“[T]here is evidence that charter schools link their practices together in comprehensive ‘innovation systems’ to focus on a

their educational methods are better than traditional public schools, but also that their management techniques are more effective and efficient, partly because they adhere to the discipline of the market and partly because they create economies of scale by purchasing in bulk and pooling aspects of back-office resources among the many schools they manage.<sup>19</sup>

North Carolina law requires charter-holders to be nonprofit corporations,<sup>20</sup> so it stands to reason that those corporations must comply with state and federal nonprofit law, whether the nonprofit corporations manage their charter schools independently or contract out the management functions. However, until now, no one has carefully examined whether those nonprofit charter-holding corporations are in fact complying with nonprofit law.<sup>21</sup> There has been legal commentary on whether charter schools and other state institutions are complying fully with North Carolina's charter-enabling statute,<sup>22</sup> and there have been legal debates over whether charter schools are subject to open meetings and public records laws.<sup>23</sup> But no one has examined North Carolina charter schools through the lens of nonprofit law. This Article aims to fill that void.

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coherent mission . . . [T]he broader institutional regime through which charter schools come to be and in which they are regulated is itself a genuine innovation.”)

19. MICHAEL FABRICANT & MICHELLE FINE, CHARTER SCHOOLS AND THE CORPORATE MAKEOVER OF PUBLIC EDUCATION: WHAT'S AT STAKE? 32 (2012) (“The scaling up of charter reform from individual schools to network is widely assumed to be the only way to ensure the economies of scale necessary to fulfill the infrastructural needs of charters including . . . billing departments, technology support services, record keeping, and teacher training that might otherwise be unavailable.”).

20. N.C. GEN. STAT. § 115C-218.1(a) (2014).

21. See *Frequent Questions*, N.C. ALLIANCE FOR PUB. CHARTER SCH., <http://nccharterschools.org/resources/faqs> (last visited Aug. 16, 2015) [hereinafter *Frequent Questions*] (discussing various state and federal laws that North Carolina charter schools must comply with but failing to mention nonprofit law).

22. See, e.g., Lukasik, *supra* note 7, at 1897–1911 (describing litigation of contested interpretations of the North Carolina enabling statute's funding formula).

23. See, e.g., Caviness v. Horizon Cmty. Learning Ctr., 590 F.3d 806, 809 (9th Cir. 2010) (stating that the Arizona Attorney General concluded charter schools were subject to open meeting laws); Cal. Sch. Bds. Ass'n v. State Bd. of Educ., 113 Cal. Rptr. 3d 550, 574 (Cal. Ct. App. 2010) (“The mere opportunity to be present at the end-stage of a behind-the-scenes evaluation process is not the equivalent of having an opportunity to be involved in the development of the standards, policies, and procedures that will govern that process.”); Zager v. Chester Cmty. Charter Sch., 934 A.2d 1227, 1232–33 (Pa. 2007) (holding that charter schools in Pennsylvania are subject to the Right-to-Know Act and are subject to public disclosure); Ann Doss Helms, *NC Education Officials: Charter Schools Must Disclose Salaries*, CHARLOTTE OBSERVER (Apr. 15, 2014), <http://www.charlotteobserver.com/news/local/education/article9113006.html>; Ann Doss Helms, *Some NC Charter Schools Violate Open Meetings Law*, CHARLOTTE OBSERVER (Mar. 16, 2014), <http://www.charlotteobserver.com/news/local/education/article9104393.html>.



*B. The Roadmap*

This Introduction concludes by describing the Article's methodological approach to studying the nonprofit legal compliance (or noncompliance) of North Carolina charter schools. Part I provides needed context by briefly describing the history of the charter school movement in North Carolina and across the United States. It also summarizes North Carolina's charter school statute, including significant recent changes to that law. Part II introduces several key state and federal nonprofit legal doctrines and offers illustrative examples of what actions North Carolina charter-holders should be taking to comply with those laws. At the state level, the legal doctrines include the nonprofit corporate fiduciary duties of care, loyalty, and obedience, and at the federal level, they include the Internal Revenue Service's ("IRS") operational test, the private inurement doctrine, the private benefit doctrine, and the intermediate sanctions regime. Part III shares some preliminary observations about whether a select group of North Carolina charter-holding nonprofit corporations are in fact complying with those state and federal nonprofit laws. The Article concludes by arguing that at least some charter schools are not complying with their nonprofit law obligations. It also offers a few recommendations about legal and regulatory reforms that state officials should consider. The Article's goal is to provide readers with a rough snapshot of North Carolina charter schools' compliance with nonprofit law and to act as an instructional roadmap to guide nonprofit charter-holding corporations, and their boards of directors in particular, in the future.

*C. Methodology*

As of May 2015, North Carolina has 146 charter schools in existence, with sixteen set to open for the 2015–2016 academic year and many more in the near future.<sup>24</sup> Whether one applauds or opposes this rapid growth, the large number of schools means that one legal scholar, even one working with the aid of a dedicated research assistant, cannot hope to thoroughly examine the nonprofit legal compliance of all of them. I therefore bit off a smaller, more manageable chunk by selecting twenty-one schools for closer examination.

This Article does not claim to be a scientific, randomized control study. In fact, the choice of these twenty-one schools was not at all

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24. Approved Charter Schools, PUB. SCH. OF N.C., <http://www.ncpublicschools.org/charterschools/schools/> (last visited Aug. 16, 2015).

random. Because legal compliance is particularly challenging where nonprofit organizations enter into comprehensive contracts with for-profit entities, I included in my study group all fifteen North Carolina schools managed by for-profit management organizations. At present, there are three such companies active in the state: Roger Bacon Academy (“RBA”), National Heritage Academies (“NHA”), and Charter Schools USA (“CSUSA”). To draw comparisons between the legal compliance of for-profit and nonprofit management companies, I included three North Carolina charter schools managed by the Knowledge is Power Program (“KIPP”), a nationally prominent CMO. Finally, I examined three independent charter schools, but even they were not randomly selected; I chose them for geographic diversity, but also because all three posted their board meeting minutes and other corporate documents on their websites. This public availability not only made my task easier, but also provided an obvious sign that the organizations are at least somewhat transparent and, therefore, presumably more likely to be in general legal compliance.

Once I identified my sample group, I examined as much information as I could find about each school, relying primarily on documents available on the public record. Where possible, I examined IRS Forms 1023 (the form that nonprofit organizations use to apply for 501(c)(3) status) and recent IRS Forms 990 (nonprofit organizations’ annual informational returns), articles of incorporation, bylaws, conflict of interest policies, CMO or EMO management contracts, and original applications to the North Carolina Office of Charter Schools.<sup>25</sup>

Several nonprofit legal doctrines focus on board members’ deliberative processes, asking, for example, whether they properly monitor their organizations’ finances, whether they engage in appropriate comparison shopping, and whether they carefully scrutinize potential conflict of interest transactions. To gain insight into these questions, I filed public records requests with each of the schools, asking them to provide copies of all board and committee meeting minutes (including the board packets associated with each meeting), as well as copies of all vendor and service contracts the organizations had entered into and additional information on the

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25. The charter applications, including their appendices, provided a trove of useful information including draft corporate policies and, for CMO- and EMO-managed schools, unsigned model management contracts. Unfortunately, the North Carolina Office of Charter Schools only posts electronic versions of applications filed after 2012.

schools' annual projected budgets.<sup>26</sup> I spent countless hours combing through all of this information, assessing the schools' corporate governance practices and legal compliance based on my many years of experience advising and representing charitable organizations and teaching a law school course called *The Law of Nonprofit Organizations*. As mentioned at the start of this discussion, my study cannot claim to be random, scientific, or comprehensive, but it does include a thorough examination of a subset of North Carolina nonprofit charter-holding corporations through the eyes of an experienced practitioner and academic.

### I. CHARTER SCHOOLS AND MANAGEMENT ORGANIZATIONS

The history of charter schools in North Carolina and across much of the United States has been marked by bipartisan support, two decades of rapid expansion, and, more recently, dissent.

#### A. *Defining Charter Schools*

Charter schools began to emerge across the United States in the 1990s, and North Carolina was part of the first wave.<sup>27</sup> Since those early days, the number of charter schools has grown dramatically. During the 1999–2000 school year, there were approximately 1,542 charter schools in the United States, compared to an estimated 6,440 as of the 2013–2014 school year.<sup>28</sup> North Carolina charter schools have followed a similar growth pattern. In the 1997–1998 school year, the first year that charters were permitted in the state, thirty-four

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26. My records request was only moderately successful. Two of the three for-profit management companies active in North Carolina—CSUSA and NHA—provided all of the documents I requested. Legal counsel for the third—RBA—initially contacted me to warn that I would be charged for all of the necessary copying and that it would prove expensive; this in spite of the fact that all other schools that responded to my request furnished electronic copies free of charge. Ultimately, RBA furnished no documents, which is not surprising given that it has waged extended legal battles with at least one North Carolina newspaper to avoid responding to record requests. See Caitlin Dineen, *StarNews Modifies its Public Records Request of Charter Day School Inc.*, STARNEWS ONLINE (Wilmington Aug. 20, 2014), <http://www.starnewsonline.com/article/20140820/ARTICLES/140829960/0/search> (describing the newspaper's ongoing legal battle with Charter Day School, managed by RBA, to comply with its public records request). Charter schools managed by KIPP, a nonprofit CMO, were reasonably responsive, as was the independently managed Tiller Academy. One of my requests failed due to my own clerical error, and two of the independent schools simply did not respond to my request, though U.S. Postal Service records indicate that they received them.

27. Lukasik, *supra* note 7, at 1887–88.

28. *Total Number of Charter Schools: 2013–2014 National*, NAT'L ALLIANCE FOR PUB. CHARTER SCH., <http://dashboard.publiccharters.org/dashboard/schools/page/overview/year/2014> (last visited Aug. 16, 2015).

charter schools opened their doors.<sup>29</sup> By 2014, there were 148 charter schools in the state serving almost 70,000 students.<sup>30</sup>

Charter schools are publicly funded, privately run schools that are tuition-free for students.<sup>31</sup> Since the beginning of the charter school movement, proponents have justified charters as “allowing individual choice [that] will stimulate competition among public schools and eventually result in a general improvement of those schools.”<sup>32</sup> To allow for innovation,<sup>33</sup> charter schools are exempt from most of the rules, regulations, and statutes that apply to other public schools,<sup>34</sup> though they are subject to the same testing requirements.<sup>35</sup> North Carolina charter schools, for example, “are not required to follow state-mandated unit plans or to coordinate their textbook[selection and purchasing] with the state department of public instruction.”<sup>36</sup> Also, charter schools generally are permitted to “hire teachers without regard to professional certification or educational background[,]”<sup>37</sup> and are allowed to hire and fire them without according them the same substantive and procedural protections enjoyed by teachers at traditional public schools.<sup>38</sup> Finally, charters are not told how to spend their money. They receive their funds in block grants, and although the boards that govern the nonprofit charter-holding corporations must account for the money and regularly audit the schools’ spending, they are free to allocate the funds as they see fit.<sup>39</sup>

Charter schools in North Carolina receive taxpayer funds based on the number of students enrolled, meaning that when a child transfers from a traditional public school to a charter, the taxpayer

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29. *The Facts on Charter Schools*, *supra* note 1.

30. *Id.*

31. Rab, *supra* note 8.

32. Andrew Broy, *Charter Schools and Education Reform: How State Constitutional Challenges Will Alter Charter School Legislation*, 79 N.C. L. REV. 493, 516 (2001).

33. *See id.* at 495 (arguing that North Carolina charter schools were originally considered educational laboratories to test new methods of instruction).

34. *See id.* at 526–27; *The Facts on Charter Schools*, *supra* note 1.

35. Broy, *supra* note 32, at 515.

36. *Id.* at 514.

37. *Id.*

38. *See* FABRICANT & FINE, *supra* note 19, at 82 (“[A]ccording to charter advocates and their allies, . . . unions have protected incompetent classroom instructors, supported a tenure system that guarantees lifetime employment to teachers not producing results in the classroom, resisted new forms of measurable accountability, and lobbied legislators with substantial resources to protect their interests . . .”).

39. *See* Broy, *supra* note 32, at 514, 528.

funding follows her.<sup>40</sup> Depending on the size of a given charter school's student body and the per-pupil spending of the traditional public schools from which the charter school draws its students,<sup>41</sup> a single charter school can take in many millions of dollars in gross revenue in a single school year.<sup>42</sup>

In spite of their access to public funding, charter schools are not created or regulated in consultation with local school districts or their elected representatives.<sup>43</sup> Groups or individuals who want to open a charter school must instead submit a detailed application to the newly created North Carolina Charter Schools Advisory Board.<sup>44</sup> The Advisory Board reviews the applications and makes recommendations to the state board of education about which organizations should receive a charter.<sup>45</sup> If and when a charter is granted to the nonprofit applicant, that organization's board of directors, which in some instances is elected by school parents and in others is self-perpetuating, is left to govern the school with oversight—some would argue loose oversight<sup>46</sup>—provided by the North Carolina Office of Charter Schools.<sup>47</sup>

The original North Carolina charter school legislation was ratified in 1996 and authorized the establishment of up to one

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40. N.C. GEN. STAT. § 115C-218.105(c) (2014); *see also* Lukasik, *supra* note 7, at 1894–98 (advocating for a change in charter school funding to eliminate the comingling of charter school and traditional public school funding); Rab, *supra* note 8 (explaining that charter schools receive taxpayer funds based on the number of students enrolled).

41. *See* § 115C-218.105(c); Broy, *supra* note 32, at 512–13 (explaining charter schools' per-pupil funding formula).

42. *See, e.g.,* Queen's Grant Cmty. Sch., IRS Form 990, Return of Organization Exempt from Income Tax pt. I (OMB No. 1545-0047) (2011) (reporting approximately \$9.4 million in gross revenue).

43. Rab, *supra* note 8.

44. *See* § 115C-218(b) (creating the Charter School Advisory Board).

45. *Id.*

46. *See* ANNENBERG INST. FOR SCH. REFORM, *supra* note 16, at 12 (arguing that across the United States monitoring and oversight by state agencies has not kept pace with the exponential growth in the number of charter schools); Erin Tracy-Blackwood, *North Carolina Charter Schools Poised to Rake in Millions*, CREATIVE LOAFING CHARLOTTE (Aug. 6, 2014), <http://clclt.com/charlotte/north-carolina-charter-schools-are-poised-to-rake-in-millions/Content?oid=3469335> (arguing that until recently the State Office of Charter Schools employed only three consultants to monitor 133 schools and now employs eight consultants to monitor 153 schools, a ratio far below the national average); *The Facts on Charter Schools*, *supra* note 1.

47. *Charter Schools*, PUB. SCH. OF N.C., OFFICE OF CHARTER SCH., <http://www.ncpublicschools.org/charterschools/> (last visited Aug. 16, 2014) (stating that its "Division Mission" is to "provide[] leadership to establish and engage a quality charter school culture resulting in legal compliance, board performance, financial integrity, and academic excellence").

hundred charter schools across the state.<sup>48</sup> The law's express intent was to provide greater choice and learning opportunities (with special emphasis on creating opportunities for learning disabled and academically gifted students), offer new professional opportunities for educators, and explore novel approaches to teaching and learning.<sup>49</sup> As will be discussed below, that original intent has recently evolved.

Support for charter schools tends to be bipartisan at both the state and federal levels,<sup>50</sup> though the different ends of the political spectrum support them for different reasons.<sup>51</sup> The political right applauds charter schools because they promote "school choice" and facilitate the introduction of market forces, such as competition and efficiency to public education.<sup>52</sup> The left tends to focus on the fact that charters facilitate community control and can create access to quality public education for low-income and minority students.<sup>53</sup>

Given that political control in North Carolina recently switched to Republican hands for the first time in a century,<sup>54</sup> and that the state's political climate has been fiercely, even toxically, partisan ever since,<sup>55</sup> it is important to recall that the state's original charter legislation was adopted with bipartisan support,<sup>56</sup> even if Republicans and Democrats have disagreed about more recent changes to the state's charter legislation.<sup>57</sup>

### B. *Evolution of North Carolina Charter School Laws and Practices*

Recent changes to charter school legislation have been rapid and numerous. For example, in 2011, North Carolina Senate Bill 8

48. *The Facts on Charter Schools*, *supra* note 1.

49. *Id.*

50. *See* Davis, *supra* note 13, at 6–7 (noting that No Child Left Behind legislation, supported by the Obama administration, creates strong incentives for the creation and/or expansion of charter schools across the United States).

51. *See id.*

52. *Id.* at 6.

53. *Id.* at 6–7.

54. Rab, *supra* note 8.

55. *See, e.g.*, John Drescher, *Drescher: Politics and the School Board*, NEWS & OBSERVER (Raleigh), Sept. 9, 2012, at A1 (describing how, while designed to be nonpartisan, the North Carolina school board operates in a "partisan manner"); Charles Meeker & Richard Vinroot, *A Needed End to Gerrymandering*, NEWS & OBSERVER (Raleigh), May 22, 2014, at A17 (discussing how gerrymandering leads to "legislative gridlock in a toxic polarizing environment").

56. *Frequent Questions*, *supra* note 21 (noting that North Carolina's public charter school legislation came about due to the bipartisan leadership of a liberal Senate Democrat (Wilber Gully) and a conservative House Republican (Steve Wood)).

57. *See supra* notes 50–53 and accompanying text.

removed the provision that had limited the number of North Carolina charter schools to one hundred at any given time, creating the possibility of an unlimited number of charter schools in the state.<sup>58</sup> The same bill eliminated limits on charter school enrollment increases, lowered minimum enrollment numbers (meaning that nonprofit organizations could operate charter schools even if they had managed to enroll only a handful of students), and removed provisions intended to prevent schools from being created to serve only specific subcategories of students (e.g., gifted students, students with disabilities, and students of the same gender).<sup>59</sup> The bill also removed the clear expectation that charter schools would be required to participate in the public school student accountability program.<sup>60</sup>

Soon after state legislators lifted the hundred-school cap on charters, they also created the North Carolina Public Charter Schools Advisory Council (“Advisory Council” or “Council”), mentioned above, to help oversee the schools and make recommendations to the Board of Education.<sup>61</sup> Fifteen panelists were appointed to the Advisory Council by Governor Bev Perdue, Republican legislators, and State Superintendent June Atkinson.<sup>62</sup> Critics of this regulatory structure pointed out that eleven of the Council members were either charter advocates or had helped run charter schools,<sup>63</sup> and that the Council included members associated with for-profit management companies whose profits depend partly on the Council’s decisions.<sup>64</sup>

Once the legislature removed quantitative limits, the number of charter schools in North Carolina increased rapidly.<sup>65</sup> In 2012, the state board of education approved twenty-three new charter schools.

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58. Act of June 17, 2011, 2011 N.C. Sess. Laws 647, 647–48 (codified as amended at N.C. GEN. STAT. § 115C-218 (2014)); see also *The Facts on Charter Schools*, *supra* note 1 (summarizing the legislative changes).

59. 2011 N.C. Sess. Laws at 647–48; see also *The Facts on Charter Schools*, *supra* note 1 (summarizing legislative changes).

60. 2011 N.C. Sess. Laws at 647. North Carolina’s public school accountability program tracks the performance of public schools through student testing and compares achievement levels among schools within the state and across the United States. See generally *Accountability Services*, PUB. SCH. OF N.C., <http://www.ncpublicschools.org/accountability/> (last visited Aug. 16, 2015) (aggregating North Carolina testing and assessment information and links).

61. Rab, *supra* note 8.

62. *Id.*

63. *Id.*

64. See Marian Wang, *Charter School Leader Turns Public Education into Private Profits*, STARNEWS ONLINE (Wilmington Oct. 15, 2014), <http://www.starnewsonline.com/article/20141015/ARTICLES/141019827/0/search> [hereinafter Wang I].

65. See *The Facts on Charter Schools*, *supra* note 1.

Nine were approved in 2011 as part of a “fast track” process.<sup>66</sup> As of March 2015, the Board of Education granted final approval to sixteen new charter schools, meaning there soon will be 162 such schools in the state.<sup>67</sup>

An important phenomenon that has accompanied the growth in charter schools is the increasing number managed by charter management organizations, particularly for-profit management organizations. According to the National Alliance for Charter Schools, an organization that advocates for charter schools and encourages their growth, as of 2010–2011 (the latest year for which statistics are available), 20.2% of charter schools nationwide were managed by nonprofit CMOs and 12.3% by for-profit EMOs.<sup>68</sup> Across the United States, the most recent trend has been a decrease in the number of for-profit managed schools, at least partly because they have been prone to scandal and legislators in jurisdictions such as Michigan and Pennsylvania have passed laws to more tightly regulate them.<sup>69</sup> But North Carolina appears to be headed in the opposite direction; since the hundred-school cap has been lifted, and since decision making regarding new charters has been turned over to a council that is friendly to CMO- and EMO-managed charter schools, the numbers appear to be on the rise.<sup>70</sup> In recent years, the Council has approved six new charter schools managed by for-profit companies.<sup>71</sup> Critics are particularly concerned about the rise of EMO-managed charter schools, fearing that they prioritize profit over educational outcomes and that, nationwide, their academic achievement records are poor<sup>72</sup>—this, at a time when the state’s

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66. See *id.*; Lynn Bonner, *State Board Set to Approve ‘Fast Track’ for Charter Schools and Online Charter Plan*, CHARLOTTE OBSERVER (Sept. 3, 2014), <http://www.charlotteobserver.com/news/local/education/article9160313.html> (referring to the increased use of “fast track” approval for North Carolina charter school operators who already have proved successful in starting a charter school).

67. List of Approved Charter Schools, *supra* note 24.

68. *Schools by Management Organization: 2010–2011 National*, NAT’L ALLIANCE FOR PUB. CHARTER SCH., <http://dashboard.publiccharters.org/dashboard/schools/page/mgmt/year/2011> (last visited Aug. 21, 2015).

69. See Patrick J. Gallo, Jr., *Reforming the “Business” of Charter Schools in Pennsylvania*, 2014 BYU EDUC. & L.J. 207, 230–31 (2014) (“The Pennsylvania General Assembly has recognized this need for reform and ‘the need to promote more sensible funding, quality in planning and governance, better fiscal and educational accountability, and more transparency in operations.’”).

70. See Rab, *supra* note 8.

71. *Id.*

72. See GARY MIRON ET AL., NAT’L EDUC. POLICY CTR., PROFILES OF FOR-PROFIT AND NONPROFIT EDUCATION MANAGEMENT ORGANIZATIONS: THIRTEENTH ANNUAL REPORT—2010–2011, at v (2012), [http://nepc.colorado.edu/files/EMO-profiles-10-11\\_0.pdf](http://nepc.colorado.edu/files/EMO-profiles-10-11_0.pdf)



regulatory institutions have failed to keep pace with the rapid growth.<sup>73</sup>

## II. NONPROFIT LAW APPLICABLE TO NORTH CAROLINA CHARTER SCHOOLS

To the uninitiated, the law of nonprofit organizations can be confounding because it is derived from a multiplicity of sources: a blend of state and federal law<sup>74</sup> with roots in the laws of trusts, corporations, and taxation.<sup>75</sup> In recent decades, courts and legislators across the country have added some clarity by increasingly relying on corporate law (as opposed to trust law), but inconsistency and confusion persist.<sup>76</sup> Determining whether charter schools in North Carolina are complying with nonprofit law thus requires the introduction and explanation of several legal concepts. For the sake of order and simplicity, the following discussion divides the world of nonprofit doctrines into state and federal, though, as the analysis will reveal, they often overlap.

### A. *State Nonprofit Law Doctrines*

For historical reasons, most nonprofit organizations in the United States are formed as corporations.<sup>77</sup> As in the for-profit world, overall responsibility for each corporation rests with its board of directors.<sup>78</sup> Nonprofit commentators generally agree that the board's job is not to micromanage the organization's day-to-day activities, but to establish and monitor the organization's mission; hire, evaluate, and, if necessary, fire the organization's chief executive; periodically assess the organization's overall performance; ensure that its finances are in order; and, crucially, verify that the organization is in

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(reporting that, of the schools managed by for-profit EMOs that had annual yearly progress ratings in the 2010–2011 school year, 51.8% did not meet state standards).

73. See *supra* note 46 and accompanying text.

74. See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 3 (10th ed. 2011) (listing various state and federal laws that apply to nonprofit organizations).

75. Thomas Lee Hazen & Lisa Love Hazen, *Punctilios and Nonprofit Corporate Governance—A Comprehensive Look at Nonprofit Directors' Fiduciary Duties*, 14 U. PA. J. BUS. L. 347, 351 (2012) [hereinafter Hazen & Hazen [Pa.]].

76. See *id.* at 352.

77. See JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 52 (4th ed. 2010).

78. Lumen N. Mulligan, *What's Good for the Goose is Not Good for the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 MICH. L. REV. 1981, 1984–85 (2007).

compliance with relevant laws.<sup>79</sup> These board responsibilities, imposed by state law, are generally described as fiduciary duties,<sup>80</sup> and scholars and practitioners group them into three categories: care, loyalty, and obedience.<sup>81</sup> For reasons discussed below, fiduciary duties do not lend themselves to bright-line formulae,<sup>82</sup> and at least one leading treatise claims that “[t]he fiduciary obligation is notably elusive as a concept.”<sup>83</sup> Still, North Carolina nonprofit law does assign fiduciary duties to nonprofit board members and, in fact, interprets those duties more strictly than many other jurisdictions.<sup>84</sup>

### 1. Duty of Care

The duty of care is in essence a duty to pay close attention to the goings-on of the corporation. Complying with this duty requires at a minimum that directors show up to board and committee meetings and read and evaluate the information that staff and other directors and officers present to them.<sup>85</sup> But the duty of care requires board members to be more than mere passive recipients of corporate information.<sup>86</sup> They also must ensure that the organization is acting properly and in adherence with the law, and they have a duty to dig

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79. *See id.* (arguing that the “board must monitor management, make decisions regarding the high-level direction of the organization, and approve its major transactions”); *see also* BUS. LAW SECTION OF THE N.C. BAR ASS’N & N.C. CTR. FOR NONPROFITS, *GUIDEBOOK FOR DIRECTORS OF NORTH CAROLINA NONPROFIT CORPORATIONS* 27–28 (2d ed. 2008) [hereinafter N.C. *GUIDEBOOK FOR DIRECTORS*] (arguing that North Carolina law requires board members to oversee operations, insist on regular reports, and be on the lookout for mismanagement, illegality, or other improprieties); Thomas Lee Hazen & Lisa Love Hazen, *Duties of Nonprofit Corporate Directors—Emphasizing Oversight Responsibilities*, 90 N.C. L. REV. 1845, 1869–70 (2012) [hereinafter Hazen & Hazen [N.C.]] (stating that the director’s “duty of oversight is premised on a duty to keep informed and to assure the organization is operating properly”).

80. It should go without saying that just as for-profit corporations are subject to a multiplicity of state laws beyond fiduciary duties, so too are nonprofits. To name just a few, they must comply with labor and employment laws, land use planning and zoning laws, and—unique to nonprofit organizations—charitable solicitation laws.

81. *See* Hazen & Hazen [N.C.], *supra* note 79, at 1861–67 (describing all three fiduciary duties under North Carolina law).

82. Hazen & Hazen [Pa.], *supra* note 75, at 349.

83. FISHMAN & SCHWARZ, *supra* note 77, at 134.

84. *See* Hazen & Hazen [N.C.], *supra* note 79, at 1872, 1867–68 (arguing that North Carolina declined to adopt recent proposed amendments to nonprofit law that would have narrowed the scope of nonprofit directors’ fiduciary duties and that the state interprets those duties strictly).

85. FISHMAN & SCHWARZ, *supra* note 77, at 151–52.

86. *Id.* at 152 (arguing every director must “take steps to become knowledgeable about background facts and circumstances before taking action” or approving others’ actions on behalf of the corporation).

into the facts when they suspect that something is amiss.<sup>87</sup> If, for example, a board member has reason to believe that staff members of a nonprofit organization are not fully informing the board about an important operational or financial issue, she has a legal duty to step in, insist on receiving the relevant information, closely examine the details, and satisfy herself that the organization is acting properly.<sup>88</sup> A director is permitted to rely on information provided by others, but only if she reasonably believes that the contents of the report or expert opinion are accurate, and she honestly assumes that the agents presenting such reports are doing so within their professional competence.<sup>89</sup>

In determining whether a given director has complied with her duty of care, North Carolina law applies a reasonableness standard, asking whether a reasonable director in like circumstances would have acted similarly.<sup>90</sup> Often, nonprofit directors' breaches of their duty of care arise because they believe that it is bad manners to ask probing questions of their organizations' managers, outside experts, and fellow board members; however, according to the law, ask they must.<sup>91</sup>

To provide a simple duty of care example specific to the North Carolina charter school context, if a director were presented with a financial report that contained line-item categories so general that she could not accurately determine what the money was being spent on, she would have a legal obligation to insist on a more detailed report with more specific information.

As discussed above in Section I.A, debates concerning North Carolina charter schools' legal compliance tend to focus on per-pupil financial allocations and the proper application of North Carolina's open records laws. These discussions overlook the fact that, because the charter-holding organizations are nonprofit, their directors must

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87. Hazen & Hazen [N.C.], *supra* note 79, at 1870.

88. FISHMAN & SCHWARZ, *supra* note 77, at 152; Hazen & Hazen [N.C.], *supra* note 79, at 1870.

89. FISHMAN & SCHWARZ, *supra* note 77, at 152.

90. Hazen & Hazen [N.C.], *supra* note 79, at 1861–63 (arguing that some states have weakened their duty of care standards by focusing more on the director's subjective state of mind and whether she believed she was acting reasonably); *see also* Hazen & Hazen [Pa.], *supra* note 75, at 356 (describing the duty of care as “basically a negligence standard as it requires directors to act in a manner consistent with reasonably prudent directors under like circumstances”).

91. FISHMAN & SCHWARZ, *supra* note 77, at 153; *see also infra* notes 120–24 and accompanying text (discussing the phenomenon of board capture).

comply with North Carolina's nonprofit laws, including the fiduciary duty of care.

## 2. Duty of Loyalty

While the duty of care focuses on process—asking whether nonprofit directors have paid sufficiently close attention and sought out clear information where it was lacking—the duty of loyalty is substantive, focusing on the director's motives, purposes, and goals.<sup>92</sup> Boiled down to its essence, the duty of loyalty forbids nonprofit directors from engaging in self-dealing, also referred to as “interested transactions.”<sup>93</sup>

Stated more expansively, the duty of loyalty requires a director to act in the nonprofit organization's best interests, even if it means harming her own.<sup>94</sup> Not only must the director avoid harming the corporation, she must avoid using her position to obtain a benefit or advantage for herself that might more properly belong to the corporation.<sup>95</sup> The paradigmatic example of such a breach is where a director is on both sides of a business transaction that involves the nonprofit organization. Imagine, for example, an insurance executive who serves on a nonprofit board that is shopping for insurance coverage.<sup>96</sup> If the executive uses his position and influence on the board to steer the insurance contract to his own company and insulate his company from market competition, he clearly has violated his duty of loyalty toward the nonprofit.<sup>97</sup>

This prohibition on self-dealing would, of course, include a prohibition against a board member using her position to arrange or approve an unwarranted expenditure of the organization's assets (also known as “corporate waste”)<sup>98</sup> where that expenditure directly or indirectly benefits the board member. To take an obvious example from the charter school context, a director who serves on the board of a nonprofit charter-holding corporation and who also is a principal of a for-profit charter management company would be violating his duty of loyalty if he were to use his influence to steer business and profits toward his own company without ensuring that the same services

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92. Hazen & Hazen [Pa.], *supra* note 75, at 380–81.

93. *Id.*

94. Hazen & Hazen [N.C.], *supra* note 79, at 1849.

95. FISHMAN & SCHWARZ, *supra* note 77, at 163.

96. *See id.* at 178–87 (presenting excerpts and analyzing a duty of loyalty case involving the sale of insurance to a nonprofit organization).

97. *Id.*

98. *Id.* at 165 (employing the term “corporate waste”).

could not be obtained more economically elsewhere. Likewise, it would be a breach of the duty of loyalty if a director were to actively assist another director in such conduct.<sup>99</sup>

It is important to emphasize that in some instances interested transactions—that is, business transactions that feature one or more directors on both sides—are not prohibited by state law and in fact can be a healthy necessity.<sup>100</sup> To return to the example of the director who is also an insurance salesman, it may be that without that board member’s intervention to persuade his own company to provide coverage, the organization would not be able to obtain insurance, at least not at a price it could afford. In such an instance, the director has reaped no direct or indirect benefit, the nonprofit organization has not been harmed, and there is no breach of loyalty.

However, any nonprofit organization contemplating such a transaction should strictly follow a procedure to examine and, in effect, sanitize the transaction in advance.<sup>101</sup> Ideally, the procedure will be laid out in detail in the organization’s written conflict of interest policy.<sup>102</sup> Typically, the procedure involves the board asking the interested director for information and requiring him to remain in the presence of the board to respond to questions and challenges.<sup>103</sup> Once the disinterested directors possess sufficient information, they should ask the interested director to leave while they analyze the information and decide if the transaction is in the corporation’s best interests.<sup>104</sup> A properly functioning board of directors would not vote on such a transaction without investigating alternative sources and engaging in comparative shopping.<sup>105</sup> Their investigation and discussion concluded, the disinterested directors should vote, outside the presence of any interested directors, on whether the proposed transaction is in the organization’s best interests.<sup>106</sup> Importantly, the disinterested directors should carefully document all of these

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99. Hazen & Hazen [Pa.], *supra* note 75, at 382.

100. FISHMAN & SCHWARZ, *supra* note 77, at 165.

101. *See id.* 186 (referring to duty of loyalty “sanitation” procedures); N.C. GUIDEBOOK FOR DIRECTORS, *supra* note 79, at 30–31.

102. Neither North Carolina nor federal law requires nonprofit organizations to have written conflict-of-interest policies, but the IRS encourages organizations to adopt them and they have become a settled aspect of nonprofit corporate best practice in recent years. *See* N.C. GUIDEBOOK FOR DIRECTORS, *supra* note 79, at 10.

103. *See id.* at 30.

104. *Id.*

105. *Id.*

106. *Id.*

sanitizing procedures in their board meeting minutes in case legal authorities suspect a breach of loyalty.<sup>107</sup>

Although state law fiduciary duties are weakly enforced in many jurisdictions,<sup>108</sup> nonprofit organizations and their directors are far more likely to be pursued for breaches of the duty of loyalty than for breaches of the duty of care.<sup>109</sup> Where duty of care violations often result in a mere slap on the wrist, blatant self-dealing can lead to dissolution of the nonprofit organization under state law in addition to other penalties.<sup>110</sup>

### 3. Duty of Obedience

Obedience is the forgotten fiduciary duty.<sup>111</sup> Although less well known, it is a firmly established aspect of North Carolina law<sup>112</sup> and is crucial for the question of charter school nonprofit legal compliance.

The duty of obedience requires nonprofit directors to ensure that the corporation devotes its resources to achieving its charitable mission.<sup>113</sup> The “directors may not deviate in any substantial way from the duty to fulfill the particular purposes for which the organization was created.”<sup>114</sup> To illustrate this duty within the context of charter schools, if the nonprofit charter-holding corporation’s charitable mission is to provide high-quality education to children, but the directors allow the corporation to be used for commercial activity and the generation of excessive profits, they would be straying from their mission and thereby violating their duty of obedience.

The duty of obedience is particularly crucial to the credibility and long-term viability of the nonprofit sector as a whole. The general public assumes that money and other resources given to a charity will be devoted to fulfilling the organization’s altruistic ends.<sup>115</sup> Their confidence is based partly on the fact that charities are subject to the “nondistribution constraint”: the requirement that insiders to the

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107. *Id.*

108. *See infra* notes 125–31 and accompanying text.

109. *See* FISHMAN & SCHWARZ, *supra* note 77, at 185.

110. Hazen & Hazen [Pa.], *supra* note 75, at 384; *see also* FISHMAN & SCHWARZ, *supra* note 77, at 185–86 (providing examples of the consequences of self-dealing).

111. *See* Hazen & Hazen [Pa.], *supra* note 75, at 388–89 (arguing obedience is not as well known as other fiduciary duties but is well known by commentators, practitioners, and courts).

112. Hazen & Hazen [N.C.], *supra* note 79, at 1864.

113. *See id.* at 1863; *see also* Jeremy Benjamin, *Reinvigorating Nonprofit Directors’ Duty of Obedience*, 30 CARDOZO L. REV. 1677, 1679 (2009) (describing the consequences of mission drift).

114. FISHMAN & SCHWARZ, *supra* note 77, at 199.

115. Benjamin, *supra* note 113, at 1685–86.

corporation not distribute excess revenues among themselves but instead reinvest it in the organization's charitable mission.<sup>116</sup> But the public also relies on directors' compliance with the duty of obedience. Even if they cannot name the legal doctrine,<sup>117</sup> citizens assume that the individuals governing the organization will adhere to its charitable purpose.<sup>118</sup> When charitable nonprofit organizations drift from their missions by, for example, allowing themselves to be used for the generation of profits for insiders, the public loses confidence, not only in that charity but also in the nonprofit sector as a whole.<sup>119</sup>

#### 4. Board Capture and Weak Enforcement

Before shifting the focus to federal nonprofit law doctrines that apply to charter schools, it is important to highlight two additional points concerning state law fiduciary duties. First, these duties are sometimes difficult for directors to adhere to because of the phenomenon of "board capture." Second, the enforcement of state nonprofit laws, especially directors' fiduciary duties, is generally lax.

Nonprofit directors' independent decision making, and thus their compliance with state law fiduciary duties, is often undermined by the belief that board membership is a gentile world and that directors are impolite if they pose probing, potentially embarrassing questions to officers, senior staff, or outside experts.<sup>120</sup> Studies on nonprofit board behavior reveal that in this atmosphere, directors rely almost exclusively on the organization's senior staff to provide them with the information they need to make decisions on behalf of the corporation.<sup>121</sup> Directors tend to rubber-stamp nonprofit managers' proposals without thoroughly debating the effects those proposals would have on the organization, even when circumstances would prompt reasonable people to engage in additional investigation.<sup>122</sup> Interestingly, and somewhat counterintuitively, nonprofit directors' deferential tendencies tend to increase along with the net worth of the organization.<sup>123</sup> At the same time, nonprofit managers have come to expect this deference: they do what they can to prevent boards from

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116. *Id.*

117. *See supra* note 111 and accompanying text.

118. *See Benjamin, supra* note 113, at 1686.

119. *See id.* at 1677–79 (arguing there is a crisis of confidence in the nonprofit sector as a result of organizations drifting from their charitable missions).

120. FISHMAN & SCHWARZ, *supra* note 77, at 153–54.

121. Mulligan, *supra* note 78, at 1987–88.

122. *See id.* at 1987 (citing various studies).

123. *Id.*

engaging in independent decision making, and they routinely complain of “meddling” board members.<sup>124</sup>

In sum, the internal structure and dynamics of nonprofit organizations tend not to foster independent decision-making by corporate boards. As the following discussion reveals, external enforcement of state law fiduciary duties also tends to be weak.

Enforcement of directors’ fiduciary duties is negatively affected by the difficulty of obtaining standing to sue for improper board behavior and the lack of enforcement resources of state attorneys general. In some jurisdictions, it is theoretically possible for citizens to bring legal action to punish directors for violating their fiduciary duties; but to obtain standing, one must show a “special and definite interest,” which the general public lacks.<sup>125</sup> This means, in effect, that standing is limited to other directors of the organization who, because of their positions, are considered to have a stake in the organization’s performance, and thus have the requisite special and definite interest. But lawsuits by directors against other directors are exceedingly rare, rendering this potential enforcement mechanism a chimera.<sup>126</sup>

In most states, the attorney general is granted broad authority to oversee nonprofit organizations.<sup>127</sup> Due to the standing challenges discussed above, it is often the attorney general or no one when it comes to the enforcement of nonprofit laws, including fiduciary duties. However, in most jurisdictions the broad authority to investigate and punish bad actors in the nonprofit sector is not matched by resources.<sup>128</sup>

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124. *Id.* at 1987–88.

125. FISHMAN & SCHWARZ, *supra* note 77, at 229; *see also* Hazen & Hazen [N.C.], *supra* note 79, at 1878–79 (referring to the difficulty of obtaining standing to sue nonprofit directors); Mulligan, *supra* note 78, at 1988 (“Traditionally, enforcement of nonprofit law has been the purview of the state attorney general.”).

126. FISHMAN & SCHWARZ, *supra* note 77, at 229. Where nonprofits are formed as membership corporations, the members generally can obtain standing to sue. Hazen & Hazen [Pa.], *supra* note 75, at 411–12 (referring to the possibility of members’ derivative actions).

127. Hazen & Hazen [Pa.], *supra* note 75, at 403; *see also* FISHMAN & SCHWARZ, *supra* note 77, at 226 (arguing attorneys general represent the public in enforcing the purposes of the corporation); Davis, *supra* note 13, at 19.

128. Hazen & Hazen [Pa.], *supra* note 75, at 408; *see also* FISHMAN & SCHWARZ, *supra* note 77, at 228 (arguing that “[s]taffing problems and a relative lack of interest in monitoring nonprofits makes attorney general oversight more theoretical than deterrent in most jurisdictions”); Mulligan, *supra* note 78, at 1991 (arguing “[m]any serious fiduciary violations simply fail to pique the interest of state attorneys general”).



This lack of resources (and perhaps interest) is evident in North Carolina.<sup>129</sup> More than a decade ago, around the time I began teaching *The Law of Nonprofit Organizations* at the University of North Carolina School of Law, I spent most of a day on the telephone trying to determine who at the North Carolina Attorney General's office was responsible for enforcing nonprofit law in the state. After being transferred to many divisions and speaking to many assistant attorneys general, I determined that one lawyer in the Attorney General's Consumer Protection Division was responsible for nonprofit enforcement, but he was only able to devote a small percentage of his time to that task.<sup>130</sup> In effect, there was virtually no enforcement of nonprofit law in North Carolina.

Taken together, the phenomena of board capture and attorney general inattention mean that, too often, no one verifies that nonprofit charter schools are complying with state nonprofit law. As the following discussion will demonstrate, the federal government in the form of the IRS takes a more stringent approach to the enforcement of nonprofit law applicable to charter schools.<sup>131</sup>

### *B. Federal Nonprofit Law Doctrines*

The discussion of federal nonprofit law governing charter schools begins with private inurement and the closely related intermediate sanctions doctrine. The latter is sometimes referred to as the "4958 rules," after the relevant section of the U.S. Treasury Code. We begin here not because these doctrines necessarily have the most impact on charter schools, but because they are clearer and more fully developed than other applicable federal laws.

#### 1. Private Inurement and Intermediate Sanctions

##### a. Private Inurement

Charitable nonprofit organizations such as those that hold North Carolina school charters are prohibited by section 501(c)(3) of the Treasury Code from engaging in activities that result in inurement of the organization's net earnings to insiders such as founders, directors,

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129. See *Hazen & Hazen* [N.C.], *supra* note 79, at 1879–80 (referring generally to the lack of nonprofit enforcement resources in the office of the North Carolina Attorney General).

130. *Cf. Fishman & Schwarz*, *supra* note 77, at 228 (reporting that a recent telephone survey found that states dedicate a median of one full-time-equivalent attorney to charity oversight and that seventeen states had no such lawyers at all).

131. See *Davis*, *supra* note 13, at 21.

and officers.<sup>132</sup> In simpler terms, individuals who use their positions of influence within charitable organizations to line their own pockets—whether through payment of excessive salaries, below-market-rate loans and other sweetheart deals, noncompetitive bidding, payment of excess rent, or improper economic gain from the sale or exchange of property with the exempt organization—violate federal law’s private inurement prohibition.<sup>133</sup>

Historically, the IRS was reluctant to find private inurement violations because there was only one possible penalty—revocation of exemption for the organization involved, otherwise known as the nonprofit death sentence—and the Service was loath to kill charities unless the violation was particularly blatant and severe.<sup>134</sup> In 1996, the extreme nature of this sanction led to a new regulatory scheme that imposed excise taxes—in effect, fines—on individuals who wield influence within nonprofit organizations and use that influence to steer excessive economic benefits to themselves.<sup>135</sup>

#### b. Intermediate Sanctions

This new scheme was called “intermediate sanctions.”<sup>136</sup> The sanctions were intermediate in that they were less harsh than the nonprofit death sentence but more severe than the mild slap on the wrist that the IRS too-often meted out for nonprofit insiders’ self-interested behavior.<sup>137</sup> Today, the intermediate sanctions regime has largely supplanted the more venerable private inurement doctrine.<sup>138</sup> Because they have become the IRS’s preferred cudgel for policing self-interested transactions by insiders, and because, as Part III of this Article will discuss, at least some charter school actors in North Carolina are arguably violating these rules, it is worth examining the new nomenclature they have created as well as their potential sting.

132. FISHMAN & SCHWARZ, *supra* note 77, at 445; *see also* I.R.C. § 501(c)(3) (2013) (providing charitable tax exemption only if “no part of the net earnings . . . inures to the benefit of any private shareholder or individual”).

133. *See* FISHMAN & SCHWARZ, *supra* note 77, at 445; John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1067 (2006) (arguing the private inurement prohibition is well established in federal law and that its purpose is to prevent insiders from “siphoning off” the exempt organization’s assets by means of non-arms-length transactions).

134. *See* FISHMAN & SCHWARZ, *supra* note 77, at 445.

135. *Id.* at 461–62.

136. *See* Colombo, *supra* note 133, at 1068 (using the name “intermediate sanctions” but also referring to the rules by their code number, section 4958).

137. FISHMAN & SCHWARZ, *supra* note 77, at 462–63.

138. Colombo, *supra* note 133, at 1068.

Section 4958 provides for excise taxes on any “excess benefit transaction,” (“EBT”) defined as a transaction in which “the value of the economic benefit provided exceeds the value of the consideration [] received.”<sup>139</sup> The sanctions only come into play when the transaction in question is between an exempt organization and a “disqualified person,” also referred to as a DQP, and defined as a person who during the preceding five years was “in a position to exercise substantial influence over the affairs of the organization.”<sup>140</sup> Stated in plain English, the intermediate sanctions rules, much like the private inurement doctrine, will punish insiders who use their positions to line their pockets or “siphon off” the nonprofit organization’s resources.<sup>141</sup>

The IRS has additional rules about who does and does not qualify as a DQP. For example, the DQP category includes family members of the person with substantial influence.<sup>142</sup> Significant for North Carolina charter schools, it also includes controlled entities: corporations or partnerships where more than thirty-five percent of the voting power is held by DQPs.<sup>143</sup> The most obvious examples of DQPs are nonprofit corporate officers, directors, trustees, and their close relatives, but the category encompasses anyone, regardless of title, who is in a position to exercise substantial influence over the organization.<sup>144</sup>

The definition of DQP is important because those are the people subject to the most extreme financial sanctions. If a DQP is found to have engaged in an EBT, she first must “correct” the excess benefit within a specified period of time, meaning she must pay back the ill-gotten gains and restore the charitable organization to the financial position it would have been in if she had been acting under the highest fiduciary standards.<sup>145</sup> In addition to “correcting” the transaction, she must pay an initial penalty of twenty-five percent of

139. I.R.C. § 4958(c)(1)(A) (2013).

140. *Id.* § 4958(f)(1)(A); *see also* Treas. Reg. § 53.4958-3(a)(1) (2002) (defining a DQP); FISHMAN & SCHWARZ, *supra* note 77, at 462–64 (discussing sanctions).

141. *See* Colombo, *supra* note 133, at 1067–68 (arguing that a “DQP” is similar to private inurement’s “insider,” and the definition of “excess benefit transaction” means, in essence, “siphoning off” the organization’s resources).

142. I.R.C. § 4958(f)(1)(B), (f)(4); *see also* Treas. Reg. § 53.4958-3(b)(1) (defining categories of DQPs); FISHMAN & SCHWARZ, *supra* note 77, at 464 (describing categories of DQPs).

143. I.R.C. § 4958(f)(1)(C), (f)(3); *see also* Treas. Reg. § 53.4958-3(b)(2) (defining categories of DQPs); FISHMAN & SCHWARZ, *supra* note 77, at 464 (describing categories of DQPs).

144. FISHMAN & SCHWARZ, *supra* note 77, at 464.

145. *See* I.R.C. § 4958(f)(6); Treas. Reg. § 53.4958-1(c)(2).

the excess benefit.<sup>146</sup> The DQP, not the organization, must pay the penalty, and if she fails to do so she may be liable for an additional second-tier penalty of 200% of the excess benefit.<sup>147</sup>

But that is not all. Financial penalties also may be imposed on one or more of the organization's "managers" who knowingly permit the organization to engage in an EBT.<sup>148</sup> Organization managers include officers, directors, trustees, and individuals with similar powers or responsibilities regardless of their titles.<sup>149</sup> If they knowingly, willfully, and unreasonably approve of or otherwise participate in an EBT, they may be fined up to the lesser of ten percent of the excess benefit or \$20,000.<sup>150</sup> If two or more managers share responsibility for approving the prohibited transaction, they will be held jointly and severally liable.<sup>151</sup>

From the perspective of nonprofit charter-holding corporations in North Carolina, the upshot of these section 4958 rules is that if any individuals affiliated with the schools' vendors—the companies that provide their books, sports equipment, school facilities, teacher training, back-office administration, or a single company that provides all of these goods and services—has influence over the organization, whether as a result of a formal board position or not, that person and every member of the board of directors could be personally subject to harsh financial penalties if the vendor is receiving more than market pay for the goods and services provided.

Before leaving the topic of section 4958, three additional features of the intermediate sanctions regime bear mentioning. First, although the intermediate sanctions regime has become the IRS's favored means of punishing self-interested transactions by nonprofit corporate insiders, the IRS reserves the right in extreme cases of wrongdoing to invoke the private inurement doctrine to kill the nonprofit organization.<sup>152</sup> Second, the law explicitly provides that the Service will be more understanding and less likely to invoke the death

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146. I.R.C. § 4958(a)(1); *see also* FISHMAN & SCHWARZ, *supra* note 77, at 463 (explaining the initial penalty of an EBT).

147. I.R.C. § 4958(b); *see also* FISHMAN & SCHWARZ, *supra* note 77, at 463 (explaining the liability of an EBT).

148. I.R.C. § 4958(a)(2); *see also* FISHMAN & SCHWARZ, *supra* note 77, at 463 (describing the lesser penalties that can be imposed on managers).

149. I.R.C. § 4958(f)(2).

150. *Id.* § 4958(a)(2), (d)(2).

151. *Id.* § 4958(d)(1).

152. *See* FISHMAN & SCHWARZ, *supra* note 77, at 463; Colombo, *supra* note 133, at 1083.

penalty where the organization identifies and corrects the EBT before the IRS discovers it.<sup>153</sup>

Finally, a nonprofit organization—including a charter school—can create a legal presumption of propriety for a transaction, even a transaction with a corporate insider/DQP, if it follows certain vetting procedures laid down by IRS regulations. Charter schools would be well advised to seek expert counsel on how to vet and sanitize any suspect transaction, but for purposes of this Article it must suffice to say that they should engage in thorough research to ensure that the amounts of money being paid to the insider/DQP are comparable to what they would pay on the open market,<sup>154</sup> and to debate and vote on the approval of the transaction without the participation of anyone who might have a personal interest.<sup>155</sup> Even if they follow these procedures, charter schools can still be found liable for intermediate sanctions, but the burden of proof in this instance shifts to the IRS, making prosecution less likely.<sup>156</sup>

## 2. The Operational Test and the Private Benefit Doctrine

The operational test and the private benefit doctrine, although separate, are conceptually related and sometimes blend together at the margins.<sup>157</sup> Combined, they are the doctrines that the IRS most often applies in the charter school context,<sup>158</sup> and therefore, are the federal doctrines about which North Carolina charter schools should be most concerned.

### a. The Operational Test

The IRS's operational test is a gateway that all aspiring 501(c)(3) organizations must pass through if they wish to earn charitable tax-exempt status.<sup>159</sup> The test is firmly grounded in the Treasury code and

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153. Treas. Reg. § 1.501(c)(3)-1(f)(2)(iii) (2013).

154. Treas. Reg. § 53.4958-6(c)(2)(i) (2002) (providing that a nonprofit board will have appropriate comparability data “if, given the knowledge and expertise of its members, it has information sufficient to determine whether . . . the compensation arrangement is reasonable or a property transfer is at fair market value”).

155. *Id.* § 53.4958-6(a)(1) to (3).

156. *See id.* § 53.4958-6; FISHMAN & SCHWARZ, *supra* note 77, at 468.

157. *See* FISHMAN & SCHWARZ, *supra* note 77, at 459 (arguing the private benefit doctrine is closely related to the operational test).

158. *See Charter School Reference Guide*, IRS, [http://www.irs.gov/pub/irs-tege/charter\\_school\\_reference\\_guide\\_12-2006.pdf](http://www.irs.gov/pub/irs-tege/charter_school_reference_guide_12-2006.pdf) (last visited Aug. 16, 2015); *Charter School Guide Sheet*, IRS, [http://www.irs.gov/pub/irs-tege/charter\\_school\\_guide\\_sheet\\_12-2006.pdf](http://www.irs.gov/pub/irs-tege/charter_school_guide_sheet_12-2006.pdf) (last visited Aug. 16, 2015).

159. *See* Colombo, *supra* note 133, at 1081 (arguing that the operational test is at the heart of tax exemption decisions).

regulations, and requires that the organization engage “primarily in activities which accomplish one or more of [the] exempt purposes specified in section 501(c)(3).”<sup>160</sup> There are eight permissible exempt purposes laid down by section 501(c)(3),<sup>161</sup> but the categories applicable to charter schools are “educational” and “charitable.” To restate the operational test within the context of North Carolina charter schools, a charter-holding nonprofit corporation will fail if more than an insubstantial part of its activities are in furtherance of something other than its charitable and educational purpose.<sup>162</sup>

One obvious example of an impermissible activity that would violate the operational test would be a charter-holding nonprofit organization distributing its net earnings to a small group of private individuals.<sup>163</sup> This is so because, by definition, a nonprofit organization cannot be charitable if it does not serve a broad charitable class, and a small group of private individuals is not a charitable class.<sup>164</sup>

It is important to emphasize that even if an organization has many activities that further legitimate exempt purposes, the organization will fail the operational test if it serves even a single substantial private interest.<sup>165</sup> To again illustrate the operational test in the context of North Carolina charter schools, if a charter-holding nonprofit organization were discovered to be using its resources to enrich private individuals rather than serve its educational purpose, it would fail the test and forfeit its tax-exempt status.

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160. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2013); FISHMAN & SCHWARZ, *supra* note 77, at 317.

161. I.R.C. § 501(c)(3) (2013) (listing permissible exempt purposes as religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international sports competition, and prevention of cruelty to children or animals).

162. Treas. Reg. § 1.501(c)(3)-1(c)(1); FISHMAN & SCHWARZ, *supra* note 77, at 317.

163. Treas. Reg. § 1.501(c)(3)-1(c)(2). Other obvious examples would be 501(c)(3) organizations that engage in substantial lobbying or any amount of political campaign activity because neither of those activities is charitable.

164. *Id.* § 1.501(c)(3)-1(d)(1)(ii); see also Andrew Megosh et. al, *Private Benefit Under IRC 501(c)(3)*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 2001, at 135, 136–37 (2001), available at <http://www.irs.gov/pub/irs-tege/eotopich01.pdf> (explaining nonprofits lose exemption “if private interests are served *other than incidentally*”).

165. Megosh, *supra* note 164, at 137; see also *Better Bus. Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279, 282–84 (1945) (ruling that the presence of private benefit, if substantial in nature, will preclude 501(c)(3) exemption regardless of an organization’s other charitable purposes or activities).

b. The Private Benefit Doctrine

The private benefit doctrine is broader and more demanding than the operational test and should be of particular concern to North Carolina charter schools, especially those that enter into comprehensive management contracts with for-profit companies.<sup>166</sup> Section 501(c)(3) does not explicitly mention the private benefit doctrine;<sup>167</sup> instead, the doctrine's origins are in the common law rule that a charitable trust must be formed for the benefit of a large and indefinite charitable class rather than for specific private individuals<sup>168</sup> and in IRS regulations related to the operational test, discussed above, that state that an organization is not operated exclusively for exempt purposes "unless it serves a public rather than a private interest."<sup>169</sup> From these humble origins the IRS and courts have developed a multi-faceted and powerful, if not always predictable and consistent, legal doctrine for policing transactions by nonprofits that benefit private, noncharitable interests.<sup>170</sup>

An illustration of the doctrine's most venerable and mundane application, one that I often use with my Nonprofit Law students, is that one cannot obtain charitable tax exemption for purposes of raising money for an individual or family afflicted by cancer. Although combatting cancer is laudable and fits within any reasonable definition of charity, the class of recipients in that case would be too narrow and would thus violate the private benefit doctrine.

By the late 1970s, however, the IRS was using the private benefit doctrine not only to police the size of organizations' charitable classes, but also to scrutinize whether charitable organizations'

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166. See Colombo, *supra* note 133, at 1064 (arguing that the IRS "relie[s] heavily on the private benefit doctrine to police economic transactions between tax-exempt charities and for-profit entities").

167. See *id.* at 1068; Megosh, *supra* note 164, at 135.

168. See FISHMAN & SCHWARZ, *supra* note 77, at 459; Colombo, *supra* note 133, at 1069 (arguing that private benefit traditionally referred to a lack of a sufficiently broad charitable class).

169. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (providing that 501(c)(3) organizations must serve "a public rather than a private interest" and also demonstrate that the organization "is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests"); see also FISHMAN & SCHWARZ, *supra* note 77, at 459 (describing the private benefit limitation); Megosh, *supra* note 164, at 135 (explaining that the language of 501(c)(3) limits private benefit).

170. See Colombo, *supra* note 133, at 1064 (arguing that the IRS "relie[s] heavily on the private benefit doctrine to police economic transactions between tax-exempt charities and for-profit entities").

benefits were impermissibly flowing to private individuals outside of the charitable class.<sup>171</sup> During that era, it was becoming increasingly common for charitable nonprofit organizations to enter into contractual business arrangements and joint ventures with for-profit entities,<sup>172</sup> and the IRS deployed the private benefit doctrine to ensure that those relationships were not being used, intentionally or negligently, to funnel charitable dollars into businesses' coffers.<sup>173</sup>

Despite the IRS's more frequent and expansive use of private benefit, the agency has never clearly defined it.<sup>174</sup> The closest it came was in 1987 when a General Counsel Memorandum declared that an organization does not qualify for 501(c)(3) status:

[I]f it serves a private interest more than incidentally . . . .

A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefitting certain private individuals . . . . To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.<sup>175</sup>

An example of the IRS's application of this expanded version of private benefit came in the context of its investigation of nonprofit credit counseling organizations. The Service found that many such organizations "violated the private benefit doctrine because [their] operations directly benefitted [for-profit] back-office service providers with whom [they] had contractual arrangements to [offer] debt consolidation loans, credit repair services, buying clubs, down-payment assistance," and various other financial products.<sup>176</sup> The IRS determined that the credit counseling nonprofits had entered into exclusive deals with the for-profit providers, effectively offloading

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171. *Id.* at 1070.

172. See generally Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law*, 73 *FORDHAM L. REV.* 2437, 2459–62 (2005) (arguing the United States charitable sector began commercializing rapidly during the Reagan administration).

173. See Colombo, *supra* note 133, at 1071–72 (describing how private benefit became the IRS's primary tool for policing the boundaries between nonprofit and for-profit organizations when they entered into joint ventures and partnerships).

174. *Id.*

175. I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987).

176. Colombo, *supra* note 133, at 1080.



most of the actual services and generating significant profits that ended up in the for-profits' bank accounts.<sup>177</sup>

Applying the terms of the 1987 General Counsel Memorandum, the private benefits flowing to the for-profit organizations were not quantitatively incidental because the for-profit firms were reaping significant profits.<sup>178</sup> Neither were the private benefits qualitatively incidental because the charitable organizations could not prove that the charitable activity could only be accomplished in ways that created the substantial private benefit—in other words, that the quantitatively substantial private benefit was unavoidable.<sup>179</sup> The IRS found no reason to believe that the nonprofit organizations could not have provided the same counseling services more efficiently if they had managed the programs themselves,<sup>180</sup> and, therefore, revoked the organizations' exempt statuses.

There are crucial differences between the older doctrines (private inurement and the traditional version of private benefit) and this newer, more expansive version of private benefit. One is that an organization such as a nonprofit credit counseling firm—or a charter-holding nonprofit corporation—might be serving a large enough charitable class, but still violating the doctrine because it is also substantially benefitting entities or individuals outside the charitable class.<sup>181</sup> Another is that, unlike private inurement, private benefit does not require that payments for goods or services be unreasonable or exceed fair market value.<sup>182</sup> Finally, unlike private inurement, the new private benefit doctrine does not require proof that board members are intentionally steering resources away from charitable

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177. *Id.*

178. *See id.*; *see also* Megosh, *supra* note 164, at 137 (arguing that in determining what is quantitatively incidental one also must consider the number of entities benefiting because “if all of an organization’s business dealings are with a single entity (or group of related entities), or promoter or developer, private benefit is more likely to be present”).

179. *See* Megosh, *supra* note 164, at 137 (arguing “*qualitatively* incidental means that the private benefit is a mere byproduct of the public benefit”).

180. The result in the credit counseling cases can also be articulated in operational test terms because the IRS found that the nonprofit organizations had violated the operational test’s “primary purpose” requirement: the nonprofit organizations were no longer primarily pursuing charitable ends and no longer primarily undertaking charitable activities because they had become more concerned with serving the private interests of the for-profit “back-office” providers than providing services to those in need. *See* Colombo, *supra* note 133, at 1080; *see also supra* notes 159–65 and accompanying text (discussing the operational test). In essence, the organizations had become “for-profit[s] in disguise.” Colombo, *supra* note 133, at 1082.

181. Megosh, *supra* note 164, at 136–37.

182. *See id.* at 138 (citing *Est of Hawaii v. Comm’r*, 71 T.C. 1067 (1979)).

activities,<sup>183</sup> or that the charity is being used as a front by a for-profit company to procure resources<sup>184</sup> (though both of those instances would furnish strong proof of private benefit). To find a private benefit violation, it suffices to show that the directors of the charity are negligently failing to conserve charitable assets by entering into transactions, even arms-length transactions, that cause an unnecessary outflow of assets to noncharitable interests.<sup>185</sup> The IRS will be more likely to find such negligent diversion of charitable assets where a charity fails to follow normal business practices by, for example, relying too heavily on a single vendor for the goods and services it needs, or failing to compare prices before making significant purchases.<sup>186</sup>

To summarize, nonprofit charter-holding corporations are subject to various state and federal nonprofit laws. At the state level, the charter-holders—their boards of directors in particular—should be concerned about violating the fiduciary duties of care, loyalty, and obedience. Overall enforcement of state nonprofit law is lax in North Carolina, but directors are more likely to be prosecuted for duty-of-loyalty violations than for violations of the duty of care or obedience. The federal government’s enforcement of nonprofit law is more robust than North Carolina’s, and charter-holding corporations should be concerned about the application of the private inurement doctrine, the intermediate sanctions regime, the operational test, and

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183. *Id.*

184. See Colombo, *supra* note 133, at 1097 (arguing that in some instances of private benefit enforcement, the IRS appears concerned that the charitable organization is being used as a front to funnel charitable assets to for-profit businesses in order to increase their market share and enhance their profits).

185. See *id.*; Megosh, *supra* note 164, at 138.

186. Megosh, *supra* note 164, at 140. One example of private benefit being applied to a charity’s arms-length transaction is revealed by Judge Richard Posner’s pithy opinion in the case of *United Cancer Council v. Comm’r*, 165 F.3d 1173 (7th Cir. 1999). There, a nonprofit board of directors negotiated a contract for fundraising services with a for-profit firm. *Id.* at 1175. The terms of the contract were overwhelmingly favorable to the for-profit, allowing it to raise millions of dollars in revenues, much of which went into its own pockets. *Id.* at 1175–76. Judge Posner rejected (incorrectly, in my view) the IRS’s claim that the fundraising firm’s contract gave it so much power that it had become an insider to the charity and thus liable for private inurement. *Id.* at 1176. However, in a puckish bit of dictum in the opinion’s closing paragraphs, he gave strong reason to believe that the IRS would have prevailed if it had brought its claim under the private benefit doctrine. *Id.* at 1179. He implicitly endorsed the notion that impermissible private benefit could occur in cases where managers of nonprofit organizations unwisely entered into economically inefficient business transactions with for-profit firms. *Id.* Stated otherwise, nonprofits that fail to responsibly conserve their charitable assets by paying too much to for-profit firms may in extreme circumstances violate the private benefit doctrine and thereby be subject to loss of exemption. *Id.* at 1179–80.

the private benefit doctrine. As the following discussion will illustrate, nonprofit charter-holders are at particular risk under those state and federal doctrines where they enter into comprehensive management contracts with for-profit companies.

### III. AN EXAMINATION OF NORTH CAROLINA CHARTER SCHOOLS' MANAGEMENT PRACTICES AND NONPROFIT LAW COMPLIANCE

This Section divides my sample of North Carolina charter schools into three roughly hewn categories. The first comprises schools for which there is strong indication of noncompliance with state and federal nonprofit law. Legal authorities should investigate these schools' operations aggressively. A second category of charter schools is operating in the gray areas that abound in nonprofit law as a result of its many "facts and circumstances" and "all the factors" tests.<sup>187</sup> These schools approach, and in some cases appear to cross over, the lines of acceptable nonprofit behavior. State and federal regulators should examine these schools' practices with care, paying particular attention to their possible noncompliance with the federal private benefit doctrine and state law duties of obedience and care. A third group of schools in my sample appears generally to be complying with nonprofit law. They operate with a reasonable degree of transparency and regularly take steps to ensure that the public funds entrusted to them are spent efficiently on the provision of charitable and educational services.

The following sections consider each of these categories in turn, beginning with a discussion of arguably noncompliant schools and ending with a brief description of several that appear to be doing things correctly. As attentive readers will ascertain, most of the dubious nonprofit behavior takes place among charter schools managed by for-profit companies.

#### A. *First Category: Schools that Appear to Violate State and Federal Nonprofit Law*

Three of the schools in my sample show distressing signs of noncompliance with nonprofit law: Charter Day School ("CDS"), Columbus Charter School, and Douglass Academy. It should not be surprising that operations at these three schools are similar, and

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187. See *supra* note 174 and accompanying text (arguing the private benefit doctrine has vague standards); see also Kelley, *supra* note 172, at 2476–82 (criticizing the IRS for using an unpredictable "all the factors" test in connection with the commerciality doctrine).

similarly troubling, because they are formally governed by a single nonprofit board of directors of CDS, which in turn is comprehensively managed by a single for-profit company, Roger Bacon Academy (“RBA”).<sup>188</sup>

#### 1. Description of RBA’s Financial and Management Practices

Obtaining detailed information on RBA-managed charter schools proved challenging. Unlike other EMO-managed schools in my sample, all of which responded to my public records requests within a reasonable period of time by furnishing electronic copies of board minutes, board packets, financial reports, and vendor contracts, the RBA-managed schools gave me nothing. As I later discovered, RBA’s reluctance to share information fits a pattern; it has resisted similar records requests from news organizations and, as a result, has been embroiled in related lawsuits.<sup>189</sup>

In spite of the reticence of the RBA-managed schools to divulge details of their finances and operations, I was able to form an opinion regarding their nonprofit legal compliance by examining the schools’ websites, IRS Forms 990 (at least those that were publicly available on Guidestar.com), and the charter applications filed by the more recently established schools.<sup>190</sup> I also benefitted from the fact that *StarNews*, a newspaper that covers southeastern North Carolina, the region in which RBA charter schools are clustered, made its own public records requests and obtained access to at least some documents.<sup>191</sup> Based on RBA’s limited response to *StarNews*’ requests, and on the paper’s own investigative reporting, it published a series of articles that revealed much about RBA and the schools

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188. RBA also manages South Brunswick Charter School. I did not examine that school’s records in detail because it did not begin operating until summer 2014, which is when I began researching this Article.

189. Dineen, *supra* note 26; see also Gareth McGrath, *StarNews Drops Charter School Lawsuit in New Hanover, but Will Refile in Brunswick*, STARNEWS ONLINE (Wilmington Dec. 9, 2014), <http://www.starnewsonline.com/article/20141209/ARTICLES/141209723/0/search?p=3&tc=pg> (discussing a lawsuit in response to CDS’s failure to respond to records requests); F.T. Norton, *Charter Day School Gets More Time to Respond to StarNews Lawsuit*, STARNEWS ONLINE (Wilmington Oct. 15, 2014), <http://www.starnewsonline.com/article/20141015/ARTICLES/141019815/0/search> (discussing the grant of an extension to CDS for the records request).

190. The North Carolina Office of Charter Schools now posts on its website electronic versions of aspiring schools’ charter applications. However, the earliest such applications are from 2012. See *Charter Applications*, PUB. SCH. OF N.C., <http://www.ncpublicschools.org/charterschools/applications/> (last visited Aug. 16, 2015).

191. Dineen, *supra* note 26.

that it manages.<sup>192</sup> My analysis relies in part on the information revealed in those articles.

RBA was founded and is owned by a controversial, outspoken individual named Baker Mitchell,<sup>193</sup> who moved to North Carolina in the mid-1990s with the express purpose of taking advantage of the state's new charter school legislation.<sup>194</sup> Mitchell also owns a for-profit property leasing company, Coastal Habitat Conservancy, whose primary activity is leasing real property and equipment to charter schools.<sup>195</sup>

From the time of CDS's establishment as a nonprofit corporation in 1999 until 2013, Mitchell served as a voting member of its board of directors.<sup>196</sup> In 2013, the North Carolina Office of Charter Schools told him that it would not approve additional charters for CDS unless he relinquished his position.<sup>197</sup> Although Mitchell resigned, or in his words, "[took] a leave of absence"<sup>198</sup> from his position as voting director, he retained his position as board secretary, which means that he is and always has been in charge of producing and maintaining all of CDS's corporate paperwork including board meeting minutes.<sup>199</sup> Mark Dudeck, who is the chief financial officer of Mitchell's for-profit companies,<sup>200</sup> joined Mitchell on CDS's board, serving as its treasurer and registered agent.<sup>201</sup>

According to an investigative report that analyzed some of CDS's board meeting minutes, Mitchell typically did not formally vote on matters in which he and his companies had an interest, but he often participated in and even directed the discussions that led up to the votes.<sup>202</sup> Even after his resignation from the board, he reportedly

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192. See, e.g., Caitlin Dineen & Pressley Baird, *Bacon Academy Management Company Earns Millions from Schools*, STARNEWS ONLINE (Wilmington June 29, 2014), <http://www.starnewsonline.com/article/20140629/ARTICLES/140629683/0/search>.

193. See Gareth McGrath, *Charter Day School Inc. Maintains Contentious Posture on Oversight*, STARNEWS ONLINE (Wilmington Oct. 21, 2014), <http://www.starnewsonline.com/article/20141021/ARTICLES/141029943/0/search>.

194. See Wang I, *supra* note 64.

195. See McGrath, *supra* note 193.

196. *Id.*

197. See Wang I, *supra* note 64 (arguing Mitchell resigned from the board after state officials told him CDS would not receive approval for an additional charter school unless he did so).

198. See McGrath, *supra* note 193.

199. *Id.*

200. See *id.*

201. *Id.*

202. *Id.*; see also Wang I, *supra* note 64 (arguing CDS board members were frustrated by Mitchell's continuing involvement in CDS governance). An interested director can end meetings in which interested transactions are discussed without violating any law or

continues to take an active role in corporate governance and, in his ongoing role as secretary, produces the written records of those discussions.<sup>203</sup>

Over the years, RBA helped establish additional charter schools in North Carolina, but rather than forming new boards of directors for each of the new schools, it consolidated governance control by having the existing CDS corporation apply for the new charters. This means that the small governing board<sup>204</sup> that once oversaw only CDS now has oversight responsibility over all RBA-managed schools.<sup>205</sup> It also means, of course, that the two interested directors, Mitchell and Dudeck, who served for many years on the CDS board, exercised influence over all of the schools.

Together, the RBA-managed charter schools receive enormous amounts of public money. Although Mitchell has fought to keep most of the financial details secret,<sup>206</sup> an investigative report that examined his first two schools' audited financial statements determined that together they collected almost \$20 million over a six-year period ending in 2013.<sup>207</sup> During the 2013–2014 school year alone, three RBA-managed schools—CDS, Columbus Charter School, and Douglass Academy—collectively received more than \$13 million in total revenues.<sup>208</sup>

It is impossible to know precisely how much Mitchell and his companies are taking home in profits,<sup>209</sup> but it is fair to surmise the returns are generous. The management contract between RBA and each of the schools declares that RBA is entitled to a fee of sixteen percent of total revenues, plus additional incentive payments based on student achievement.<sup>210</sup> So, for example, during the 2013–2014

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breaching a fiduciary duty. It is only when an interested director exercises control or intimidation over the vote that a violation could result.

203. See McGrath, *supra* note 193.

204. See *Board of Trustees*, CHARTER DAY SCH., <http://charterdayschool.net/leadership/board-of-trustees/> (last visited Aug. 16, 2015) (listing five members of the board of directors).

205. See *id.* (listing four charter schools governed by the CDS board of directors).

206. See *supra* note 190 and accompanying text.

207. Wang I, *supra* note 64.

208. Dineen & Baird, *supra* note 192.

209. Wang I, *supra* note 64.

210. See Educational Service Provider Agreement Between Roger Bacon Academy and Douglass Academy §§ 6.03, 6.10 [hereinafter Douglass-Bacon Agreement], <http://www.ncpublicschools.org/docs/charterschools/resources/application/2014apps/douglassacademy.pdf> (naming RBA's management fee as sixteen percent of total revenue and providing for performance-based incentive payments); Dineen & Baird, *supra* note 192.

school year, two of the schools paid RBA almost \$2.4 million in fees and incentives out of just under \$13 million in total revenue.<sup>211</sup>

However, focusing exclusively on management fees significantly understates the amount of money flowing through CDS and into RBA's coffers. Lease payments for real estate are a large source of RBA's revenue. During the 2013–2014 school year, for example, CDS and Columbus Charter School paid Coastal Habitat Conservancy, an RBA-affiliate controlled by Mitchell, approximately \$1.5 million to rent their facilities, plus nearly \$549,000 for maintenance.<sup>212</sup>

In addition to leasing its real estate from a Mitchell-controlled company, the schools rent or buy practically everything else they need from either RBA or Coastal Habitat Conservancy: books, furniture, desks, computers, teacher training, and sports equipment.<sup>213</sup> To focus on one sample, CDS's 2010 Form 990 reported the details of business transactions it entered into with "interested persons,"<sup>214</sup> and said that it engaged in six such payments, including a \$1.6 million management fee, \$550,000 for "staff development and supervision," \$170,000 for "back office support," \$965,000 for "building rent – classrooms," \$83,000 for "building rent – admin offices," and \$318,000 for "misc. equipment rental."<sup>215</sup> Based on this evidence, CDS paid insiders (presumably the companies controlled by Mitchell) at least \$3,686,000 in a single year. CDS's 2011 Form 990 shows payments to interested parties rising to \$4,137,000.<sup>216</sup> Best of all, at least from the perspective of RBA and Coastal Conservancy, these insiders never have to wait for their money. Under Article VI of the management agreement between CDS and RBA, CDS is obligated to establish a joint bank account and deposit all revenues within three days of receipt.<sup>217</sup> RBA

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211. Dineen & Baird, *supra* note 192 (noting also that the third RBA-managed school's management fee was waived amidst a state investigation into low enrollment).

212. *Id.*

213. McGrath, *supra* note 193; see also Caitlin Dineen, *Baker Mitchell Companies Benefit Directly from Charter Day Nonprofit He Started*, STARNEWS ONLINE (Wilmington June 29, 2014), <http://www.starnewsonline.com/article/20140629/ARTICLES/140629682> ("[D]ocuments provided by the Charter Day School Inc. shows [sic] that the nonprofit group owns very little, if any, of the land, buildings, furniture or equipment used by its three schools. Instead, the schools rent most of their material goods from founder Baker Mitchell's two for-profit companies—Roger Bacon Academy and Coastal Habitat Conservancy."); Dineen & Baird, *supra* note 192 (same).

214. See Charter Day Sch., IRS Form 990, Return of Organization Exempt from Income Tax pt. IV (OMB No. 1545-0047) (2010).

215. *Id.*

216. Charter Day Sch., IRS Form 990, Return of Organization Exempt from Income Tax pt. IV (OMB No. 1545-0047) (2011).

217. See Douglass-Bacon Agreement, *supra* note 210, § 6.01.

can draw from that account whenever it desires to pay itself or its affiliates, and in whatever amount it wishes.

It is significant that nothing in CDS's corporate minutes indicates that the goods and services that Mitchell's for-profit companies sold or leased to CDS were subject to any competitive bidding, comparative shopping, or price negotiation.<sup>218</sup> A passage from CDS's 2010 Form 990 is particularly revealing in this regard.<sup>219</sup> In response to a question about whether CDS had engaged in any EBTs (meaning they had paid too much for a good or service provided by a DQP)<sup>220</sup> during the previous fiscal year, CDS responded that it had not, and that "the LLC consistently compares prices against the rent paid to Coastal Habitat Conservancy."<sup>221</sup> In other words, the response indicated that CDS's governing board was not verifying that the prices being charged were fair, but "the LLC"—meaning RBA—was.<sup>222</sup> The upshot is that, with seemingly little inquiry or input from the charter schools' independent directors, representatives of the for-profit management company decided what was reasonable to charge for the services they provided.

## 2. The Application of Nonprofit Legal Doctrines to RBA-Managed Schools

### a. Private Inurement and Intermediate Sanctions

Although the devil is in the details—details that RBA appears determined not to reveal—evidence exists to indicate private inurement violations arising out of the management of the three schools governed by the CDS board of directors. There can be no doubt that at least two insiders to the CDS board of directors—Baker Mitchell and Mark Dudeck<sup>223</sup>—have been on both sides of numerous,

218. See Wang I, *supra* note 64.

219. Charter Day Sch., IRS Form 990, Return of Organization Exempt from Income Tax pt. III (OMB No. 1545-0047) (2010).

220. See *supra* Section II.B.1.b.

221. Charter Day Sch., IRS Form 990, Return of Organization Exempt from Income Tax pt. V (OMB No. 1545-0047) (2010).

222. See Dineen, *supra* note 213 (reporting that in CDS's early years, Mitchell signed most bid documents on behalf of Coastal Habitat and RBA and an illegible signature signed for the school; after Dudeck joined the RBA about seven years ago, he began signing the documents); see also Wang I, *supra* note 64 (arguing that when CDS was first trying to obtain federal tax exempt status, it furnished the IRS with assurances that its facility lease was evaluated for fairness by an independent real estate professional when in fact that professional worked for the same real estate firm as the board chair's husband).

223. One could argue that RBA itself has become an insider to CDS as a result of its comprehensive control over all aspects of CDS's operations and finances. In accordance with this argument, payments from CDS to RBA and its affiliates would be considered



substantial financial transactions that amount to many millions of dollars.<sup>224</sup>

It is possible, of course, that all of the charitable dollars paid by CDS to Mitchell's for-profit companies were properly vetted by the CDS board of directors with no influence by Mitchell or Dudeck, and it is possible that all of those transactions were in fact fair, even beneficial, to CDS.<sup>225</sup> It is also possible that disinterested CDS directors maintained careful records of their factual investigations and deliberations concerning potential conflict of interest transactions involving Mitchell and Dudeck, and that they simply do not wish to share those records in spite of their legal obligation to do so.<sup>226</sup>

But evidence indicates otherwise. Mitchell is reported to have participated in and even led board discussions that ultimately approved these self-interested arrangements.<sup>227</sup> There is nothing to indicate that disinterested directors at CDS took action to verify that the organization was getting a fair deal for the goods and services being provided by insiders Mitchell and Dudeck. Therefore, it is reasonable to suspect that Mitchell and Dudeck were doing exactly what the private inurement doctrine forbids: using their influence to steer excessive economic benefits to themselves, or, in slightly more vernacular terms, lining their own pockets with charitable dollars.<sup>228</sup>

The IRS is unlikely to pursue CDS for private inurement because the only possible punishment is loss of exempt status,<sup>229</sup> which would unfairly harm the children that attend the school and the community that surrounds it. Instead, intermediate sanctions are a more probable avenue of inquiry.

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insider transactions and subject to private inurement scrutiny. A similar argument was rejected by Judge Posner in *United Cancer Council v. Commissioner*, 165 F.3d 1173 (7th Cir. 1999), but I believe Judge Posner's private inurement analysis in that case was flawed. Because the IRS's newer intermediate sanctions laws leave little doubt that RBA could qualify as a DQP, it is unlikely that the IRS or anyone else will challenge RBA (or Judge Posner's decision) by pursuing this theory.

224. See *supra* notes 196–216 and accompanying text.

225. See *supra* Section II.A.2, II.B.1.a (discussing the requirements of the state law duty of loyalty and federal private inurement requirements).

226. See *supra* Section II.B.1.a (discussing federal private inurement requirements).

227. See *supra* notes 202–03 and accompanying text.

228. See *supra* Section II.B.1.a. Even if CDS could produce board meeting minutes purporting to show that the insider transactions were properly investigated and approved by disinterested directors, a thorough investigator would treat such records with at least some skepticism given that Mitchell himself acts as the board's secretary and thus presumably has a large hand in creating the organization's paper trail.

229. See *supra* Section II.B.1.a.

Mitchell and Dudeck, the affiliated for-profit companies with which they are associated, and the directors and other principals of CDS, should be concerned about the IRS's intermediate sanctions rules because violation can lead to cripplingly large financial penalties, particularly in instances such as this one where millions of dollars are flowing through a charitable organization and ending up in the pockets of DQPs.<sup>230</sup> Based on Mitchell's long-term position on CDS's board of directors, his years of holding the office of corporate secretary, and indications that he takes an active role in guiding and governing the organization, there is little doubt that he qualifies as a DQP for intermediate sanctions purposes. Because the status of DQP does not depend on formal titles, it would make no difference for intermediate sanctions purposes that Mitchell recently resigned as a voting director,<sup>231</sup> especially since evidence indicates that he retains not only his officer position but also his influence over the organization.<sup>232</sup> Dudeck, who within the statute's five-year look-back period also has served as a voting board member and treasurer of CDS, would also almost certainly qualify as a DQP. Finally, assuming Mitchell controls more than thirty-five percent of RBA and Coastal Habitat Conservancy, they too would be considered DQPs.<sup>233</sup>

The remaining question would be whether any or all of the transactions entered into between CDS and the for-profit companies constituted EBTs. CDS's board of directors can shift the burden of proving the existence of an EBT to the IRS if CDS's disinterested board members engaged in statutorily required comparison-shopping to determine whether CDS received value for the charitable dollars it turned over to DQPs.<sup>234</sup> However, nothing on the available record indicates that such vigorous comparison-shopping took place.

If the IRS determines that CDS has overpaid for any or all of the services it has received from RBA, Coastal Habitat Conservancy, and any other affiliated for-profit companies, the financial consequences could be severe. Many millions of public, charitable dollars have flowed through CDS during the previous five years.<sup>235</sup> If some of those millions constituted excess benefit payments, the IRS could compel the DQPs—the individuals, the companies, or both—to pay

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230. See *supra* Section II.B.1.b (describing DQP); see also *supra* notes 210–16 and accompanying text (describing the dollar volumes flowing through CDS).

231. See *supra* Section II.B.1.b (noting that DQP status does not depend on formal titles).

232. See *supra* notes 195–202 and accompanying text.

233. See *supra* Section II.B.1.b.

234. See *supra* Section II.B.1.b.

235. See *supra* notes 195–202 and accompanying text.

back the overcharges plus a fine calculated as twenty-five percent of the excess benefits.<sup>236</sup> If the remaining, disinterested directors are shown to have knowingly, willingly, and unreasonably permitted those transactions to take place, they too could be fined up to a maximum of \$20,000.<sup>237</sup>

b. State Law Fiduciary Duties

Although the leaders of CDS and the for-profit companies that animate it should be most concerned about the application of federal law, their actions could also be subject to sanction under North Carolina law. If, for example, Mitchell and Dudeck have used their influence over the CDS board of directors to steer excessive charitable and public dollars to their for-profit companies and, indirectly, to themselves, they obviously would be in violation of their fiduciary duty of loyalty.<sup>238</sup> If the disinterested directors on CDS's board failed to investigate and, where warranted, challenge the insider transactions carried out by Mitchell and Dudeck, they arguably would be in violation of their fiduciary duty of care.<sup>239</sup> Finally, if indeed charitable dollars intended for CDS's educational mission were impermissibly diverted into the coffers of RBA and its affiliates and converted into profits for its principals, all of the board members would be in violation of their fiduciary duty of obedience.<sup>240</sup>

Mitchell clearly does not like probing questions or criticism,<sup>241</sup> and he is not shy about justifying his actions, particularly when others have accused him, his associates, and the institutions he controls of impermissible behavior. In response to allegations that he was engaged in conflicts of interest, his response was “[u]ndue influence, blah blah blah.”<sup>242</sup> He apparently was not aware that, as a director of a nonprofit corporation, he was subject to legal duties under federal and state law to be scrupulously attentive to conflicts of interest.

Mitchell further argues that there is nothing impermissible about reaping significant corporate profits from charter school

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236. See *supra* Section II.B.1.b.

237. See *supra* Section II.B.1.b.

238. See *supra* Section II.A.2.

239. See *supra* Section II.A.1.

240. See *supra* Section II.A.3.

241. See Gareth McGrath, *Baker Mitchell Sues Pruden over Criticism of Charter Schools*, STARNEWS ONLINE (Wilmington Jan. 9, 2015), <http://www.starnewsonline.com/article/20150109/ARTICLES/150109714/0/search> (reporting on a lawsuit he filed against a critic); *supra* note 189 and accompanying text (describing Mitchell's reluctance to comply with requests for information).

242. Wang I, *supra* note 64.

management. To Mitchell, his schools are simply an example of the triumph of the free market. He has been quoted as stating derisively that “[p]eople here think it’s unholy if you make a profit” from schools.<sup>243</sup> “In a free-market capitalistic society, the quality of results determines success or failure and ensures efficiency in the delivery of goods and services.”<sup>244</sup> Referring to himself in the third person, he has said “[m]aybe Baker Mitchell gets a huge profit. Maybe he doesn’t get any profit. Who cares?”<sup>245</sup>

Once again, if Mitchell had been briefed by his attorneys on the basics of nonprofit law, he would realize that several different doctrines, most notably and obviously in his case the federal intermediate sanctions doctrine, the federal private inurement doctrine, and North Carolina fiduciary duties of loyalty and obedience, place upon him and his fellow directors a legal obligation to care how big his companies’ profits are.<sup>246</sup>

As a corollary to the argument that no one should care about his and his companies’ profits, Mitchell has argued that all that matters is that RBA is providing quality education to the students who attend the schools it manages.<sup>247</sup> The proof is in the pudding, he claims, because his students typically perform better on standardized tests than students at nearby traditional public schools.<sup>248</sup> This argument again ignores the fact that he and his colleagues on the nonprofit board are subject to legal obligations to take into account not just the charitable and educational outcomes, but whether those outcomes are being achieved without wasting charitable public dollars.<sup>249</sup>

243. *Id.*

244. McGrath, *supra* note 193.

245. Wang I, *supra* note 64.

246. Mitchell’s attitude betrays a fundamental misunderstanding about the nature of the nonprofit sector. As I often tell my Nonprofit Law students, “We the People,” meaning the tax-paying members of the public, are silent third parties in transactions between charitable and for-profit organizations. Most citizens who pay taxes, and who through the tax code subsidize the activities of charitable organizations such as CDS, have little or no opportunity to evaluate whether our money is being spent wisely and efficiently. That is why we entrust legal authorities, namely the IRS and states’ attorneys general, to monitor those transactions and look out for our interests.

247. McGrath, *supra* note 193.

248. *See* Wang I, *supra* note 64.

249. *See supra* Section II.A.3 (describing the duty of obedience). In addition, although it is for the most part legally beside the point—nonprofit directors simply cannot waive away concerns about private inurement and related legal doctrines by pointing to positive outcomes—it bears mentioning that Mitchell arguably overstates the quality of his schools’ educational achievements. Critics allege that Mitchell’s schools engage in the cream skimming described in Part I of this Article, meaning they enroll comparatively low percentages of needy students whose standardized test scores tend to be lower. *See* Wang I, *supra* note 64. To take one example, in 2014, thirty-seven percent of test takers at the

Finally, Mitchell has responded to allegations of his and his companies' self-serving behavior by claiming that the companies are responsive to and firmly under the control of the charter schools and their board. As he is fond of saying, "parents can shut us down overnight. They stop bringing their kids here? We don't get any money."<sup>250</sup> This assertion, while technically true, ignores the reality of the comprehensive contractual relationship between the nonprofit schools and the for-profit management companies.

In fact, to fire RBA would be to commit institutional suicide. Under the terms of the contract that the RBA-managed schools have signed, all of the millions of dollars in public funds that flow to the schools are made almost immediately available to the management company, which has the power to spend those funds in any way it chooses so long as it provides the promised educational services. Instead of using those funds to purchase goods on behalf of the school—land, buildings, furniture, computer equipment, books, and everything else that goes into educating children—RBA takes the money and, on behalf of the school, rents or leases to the school all of those necessary inputs.<sup>251</sup> From whom does it lease the goods and services? From RBA and its for-profit affiliates, of course!<sup>252</sup>

This means that if the board of directors grew dissatisfied, either with the quality of RBA's services or with the extent of its profit-taking, and decided to discontinue the relationship, they would be left with absolutely nothing: no teachers, no curriculum, no school building, no land, no books, no sports equipment, nothing.<sup>253</sup> To illustrate the aftermath of firing RBA, one can visualize the scene in the 1960s television program, *Dr. Seuss' How The Grinch Stole Christmas*, when the Grinch stuffs the Christmas tree up the chimney at Cindy Lou Who's house and steals away into the night. All he

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RBA-managed Columbus Charter School were "economically disadvantaged," compared to the county's seventy-four percent. *Id.* This low percentage of economically disadvantaged students is at least arguably by design, since Columbus Charter School does not provide transportation or a federally supported free and reduced-price lunch program for its students—both of which are necessary if a school is to attract lower-income students. *Id.*

250. Wang I, *supra* note 64.

251. *See id.*

252. *Id.*

253. *See* Jennifer Dixon, *Public Money for Schools Buys Private Property*, DETROIT FREE PRESS (Dec. 14, 2014), <http://www.freep.com/story/news/local/michigan/2014/12/14/charters-national-heritage-academies-tax-dollars-school-contents/20357559/> (arguing that a for-profit management company's ownership of both the school building and its contents means charter school boards have "little leverage to remove the company if they are unhappy with [its] stewardship").

leaves behind is a “crumb that was even too small for a mouse.”<sup>254</sup> The schools governed by CDS would find themselves similarly stripped if they were to challenge or fire RBA, which renders doubtful Mitchell’s claim that they are capable of independent oversight.<sup>255</sup>

To conclude the discussion of North Carolina charter schools whose practices are of doubtful rectitude when examined through the lens of nonprofit law, it should be emphasized that RBA-managed schools are not the only ones with compliance problems. To take one example, recent news reports indicate that an independent charter school in Kinston, North Carolina had its charter suspended for grossly negligent financial practices that led to insolvency.<sup>256</sup> In a similar vein, I recently heard an anecdote from a reporter who asked a rural North Carolina independent charter school for copies of its recent Forms 990. School officials responded that the Office of Charter Schools took care of all the paper work for them. Obviously, they were not well informed about their duties under nonprofit law.

Thus, although the RBA-managed charter schools are not alone in their dubious nonprofit law compliance, they are the only ones in my sample. Charity regulators, particularly the IRS, should bring their investigative power to bear to determine if in fact the law is being broken.

*B. Second Category: North Carolina Charter Schools Operating in Nonprofit Law’s Gray Areas*

Two clusters of North Carolina charter schools fall into this second category, and each cluster is managed by a for-profit EMO. National Heritage Academies, headquartered in Grand Rapids, Michigan, manages charter schools across the United States.<sup>257</sup> I examined five NHA schools located in North Carolina, including

254. *How the Grinch Stole Christmas! (TV Movie 1966)*—Quotes, IMDB, <http://www.imdb.com/title/tt0060345/quotes> (last visited Aug. 16, 2015).

255. See Marion Wang, *When Charter Schools Are Nonprofit in Name Only*, PRO PUBLICA (Dec. 9, 2014, 11:49 AM), <http://www.propublica.org/article/when-charter-schools-are-nonprofit-in-name-only> [hereinafter Wang II] (arguing similarly situated schools in Ohio fired and sued their for-profit management firm but had difficulty continuing because they had turned over most of their assets to the for-profits and had little left with which to relaunch the schools).

256. See Lynn Bonner, *NC Audit Finds Financial Mismanagement at Closed Charter School: Ex-CEO Disputes Findings*, NEWS & OBSERVER (Raleigh Jan. 28, 2015), <http://www.newsobserver.com/2015/01/28/4512207/audit-finds-financialmismanagement.html> (reporting on alleged mismanagement of a North Carolina charter school).

257. See *School Directory*, NAT’L HERITAGE ACAD., <https://www.nhaschools.com/en/Our-Schools/Pages/School-Directory.aspx> (last visited Aug. 16, 2015).

Forsyth Academy, Greensboro Academy, PreEminent Charter Academy, Queens Grant Community School, and Research Triangle Academy. The second for-profit company, Charter Schools USA (“CSUSA”), is located in Fort Lauderdale, Florida and manages schools in seven different states.<sup>258</sup> I examined three CSUSA schools in North Carolina, including Cabarrus Charter Academy, Cardinal Charter Academy, and Langtree Charter Academy. The following discussion, which is based on my review of thousands of pages of documents that each company supplied in response to my public records requests,<sup>259</sup> analyzes the school clusters separately since their management practices differ from one another. However, because the management practices of the schools within each cluster are practically identical, the analysis for the most part treats each cluster as a single unit. I begin with the NHA cluster of schools.

#### 1. Description of Financial and Management Practices of Schools Managed by National Heritage Academies and Charter Schools USA

The most noteworthy aspect of the relationship between NHA and its North Carolina charter schools is that it is governed by what the industry calls “sweeps” contracts.<sup>260</sup> The term “sweeps” refers to the fact that practically every dollar that comes from public sources into the nonprofit charter-holding corporations is instantaneously swept out of their bank accounts and deposited into NHA’s.<sup>261</sup> In exchange, NHA undertakes to provide the nonprofit charter-holder with everything necessary to start and run a successful charter school: curricula, teachers, teacher training, real estate,<sup>262</sup> furniture,

258. See *Our Schools*, CHARTER SCH. USA, <http://charterschoolsusa.com/our-schools/> (last visited Aug. 16, 2015).

259. See *supra* Introduction, Section C.

260. See Wang II, *supra* note 255 (employing and explaining the term sweeps contract).

261. See Management Agreement Between National Heritage Academies, Inc. and Greensboro Academy art. V.A (May 18, 1999) [hereinafter Greensboro Acad. Mgmt. Agreement] (on file with the North Carolina Law Review); Wang II, *supra* note 255.

262. See Greensboro Acad. Mgmt. Agreement, *supra* note 261, at art. III, IV. In addition to the management contract, NHA enters into lease agreements with each of the schools for the provision of its facilities. See Lease Agreement Between National Heritage Academies and Greensboro Academy, at Recitals (Oct. 7, 1999) [hereinafter Greensboro Acad. Lease Agreement] (on file with the North Carolina Law Review). Technically, they are subleases because NHA leases the facilities from its own property development affiliate, Charter Development Company, LLC, and then subleases the property to the school. *Id.* The lease terms make clear that if the school loses its charter or for any reason terminates its relationship with NHA, the management company takes back the building along with everything in it. *Id.* at art. 13. The tenant—meaning the charter school nonprofit—pays all upkeep, utilities, taxes, and insurance. *Id.* at art. 5–7. This is conceptually confusing, since in fact NHA takes all of the school’s revenue before the

equipment, administrative support, accounting and financial services, etc.<sup>263</sup> Notably, practically everything leased or purchased under the contract remains the property of NHA in case the contract is terminated.<sup>264</sup> Once NHA provides the promised goods and services, it retains all leftover money as its management fee.<sup>265</sup> Another contract provision, one that at first blush appears innocuous, acknowledges that NHA manages multiple charter schools, that there are certain NHA administrative services that cannot easily be attributed to a single school, and that NHA retains the right to attribute these expenses to the various schools on whatever reasonable basis it decides.<sup>266</sup>

The contract provides the charter-holding nonprofit organization the right to hire an independent consulting firm to evaluate NHA's services, but any such consultation must be paid for out of board discretionary funds.<sup>267</sup> Given that the boards' discretionary funds amount to no more than \$35,000 per year<sup>268</sup> (out of a typical annual budget of anywhere between \$4 million and \$6 million),<sup>269</sup> and that, based on my review of meeting minutes, the boards usually spend all of those funds on sports coaches and equipment, after-school enrichment programs, conference travel, teacher recognition, karaoke machines, furniture for the parent lounge, and countless other purposes, the right to hire an outside consultant seems mostly

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school gets its hands on it, and pays itself for rent and upkeep. *Id.* at art. 3. Under Paragraph 3.5 of the lease, the nonprofit also agrees that if NHA makes capital improvements to the property, it may raise the rent to compensate itself. *Id.* at art. 3, para. 5. In sum, under the terms of the lease there is virtually no way for NHA to lose. It takes the organization's money, pays itself whatever it wants in rent, and reimburses itself for any and all real-estate-related expenses. *Id.*

263. Wang II, *supra* note 255.

264. Greensboro Acad. Mgmt. Agreement, *supra* note 261, at art. VII.B.2. However, under the agreement, "[a]ssets owned by the Academy shall remain the property of the Academy." *Id.*

265. *See id.* at art. V.C.

266. *Id.* at art. V.E.

267. *Id.* at art. IV.F.

268. *See* National Heritage Academies Draft Services Agreement art. VII.D (Apr. 13, 2012) [hereinafter NHA Draft Services Agreement], available at <http://www.ncpublicschools.org/docs/charterschools/resources/application/2014apps/summerfield.pdf> (depicting a model management agreement submitted as part of NHA's charter application to the North Carolina Office of Charter Schools for Summerfield Charter Academy). Additionally, under the agreement, the board's discretionary account is defined as \$35,000 or two percent of per-pupil allocations. *Id.*

269. *See, e.g.*, Board Meeting Minutes, Forsyth Acad. Bd. of Dirs. (Nov. 14, 2006) (on file with the North Carolina Law Review) (projecting an annual budget of \$4.4 million); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Feb. 11, 2014) (on file with the North Carolina Law Review) (projecting an annual budget of approximately \$5.5 million).



theoretical. In my review of thousands of pages of board documents, I never saw evidence that any board member considered bringing in an outside expert or otherwise engaging in any form of neutral evaluation or comparative shopping.

Either party may terminate the management contract upon ninety days' notice.<sup>270</sup> However, as was true with the RBA-managed schools, the contract's "Grinch" provision ensures that the nonprofit organizations would commit institutional suicide if they were to exercise the termination right since practically all school-related property would remain with NHA.<sup>271</sup>

The management contract between NHA and its charters requires NHA to keep the schools' boards of directors reasonably informed of the school's operations so that the boards can provide oversight.<sup>272</sup> In many respects, NHA appears to honor this commitment. Based on my review of years' worth of board minutes at different NHA-managed schools, most board meetings include a Principal's Report in which the school principal, who invariably is an NHA employee, provides directors an overview of important developments since the previous meeting.<sup>273</sup> NHA also regularly provides copies of school-related policies and procedures and seeks directors' approval. In recent years, the company has involved the directors in personnel decisions by furnishing applicants' resumes and employment questionnaires and seeking directors' approval. Also in recent years, NHA has created an online School Performance Dashboard Suite that gives directors access to current statistics about school enrollment, school achievement, and parent satisfaction, among other metrics.<sup>274</sup> Most board meetings also include discussions and votes related to the expenditure of the board's discretionary funds.<sup>275</sup> Significantly, some meeting minutes record the presence of a

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270. NHA Draft Servs. Agreement, *supra* note 268, at art. II.B.3.

271. See *supra* notes 253–54 and accompanying text.

272. See, e.g., Greensboro Acad. Mgmt. Agreement, *supra* note 261, at art. III.A, V.F (requiring NHA to remain generally accountable to the board and to furnish the board with regular financial reports).

273. See, e.g., Board Meeting Minutes, Forsyth Acad. Bd. of Dirs. (Jan. 14, 2014) (on file with the North Carolina Law Review) (including a Principal's Report and a School Performance Report).

274. See, e.g., Board Meeting Minutes, Forsyth Acad. Bd. Of Dirs. (Aug. 13, 2013) (on file with the North Carolina Law Review) (referring to the School Performance Dashboard Suite).

275. See, e.g., Board Meeting Minutes, Forsyth Acad. Bd. of Dirs. (Apr. 5, 2001) (on file with the North Carolina Law Review) (approving the spending of board funds for purchase of a kiln); Board Meeting Minutes, Forsyth Acad. Bd. of Dirs. (Feb. 3, 2000) (on file with the North Carolina Law Review) (approving the spending of board discretionary

lawyer, who presumably would be available to answer questions if the board members had any.<sup>276</sup>

At first blush, NHA also appears to furnish each school's board members with thorough and timely financial information. In the late spring of each school year, a NHA finance officer presents each school's board with a projected budget for the following school year.<sup>277</sup> That proposed budget is then revised periodically throughout the school year to reflect changes in revenues and expenses.<sup>278</sup> In addition, the finance officer provides quarterly financial reports showing year-to-date revenue and expense figures.<sup>279</sup>

However, after examining scores of such finance reports that stretch over more than a decade, I was struck by two serious shortcomings. First, there is virtually no indication that any director ever asked any question about the figures presented in the reports. Second, over time, the reports themselves became more and more

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funds for a karaoke system); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Oct. 5, 2004) (on file with the North Carolina Law Review) (approving the spending of several \$500 coaching stipends); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Oct. 4, 2001) (on file with the North Carolina Law Review) (approving the spending of board funds for craft materials); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Apr. 5, 2001) (on file with the North Carolina Law Review) (approving the spending of board funds for athletic equipment, a laminating machine, and conferences); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Jan. 4, 2001) (on file with the North Carolina Law Review) (approving the spending of board funds for "shelving"); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (June 1, 2000) (on file with the North Carolina Law Review) (approving the spending of board funds for flags, flagpoles, and conference travel); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Oct. 7, 1999) (on file with the North Carolina Law Review) (approving the spending of board discretionary funds on musical instruments).

276. It raises an interesting ethical issue, one beyond the scope of this Article, whether the attorney can in fact provide disinterested advice to the board of directors, particularly when that advice might be adverse to the interests of NHA. After all, NHA pays all of the bills for the charter school and, under the management contract, has extremely broad discretion to decide whom to pay. Still, in at least a few instances, the attorney appeared to provide directors with independent advice. *See, e.g.*, Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (July 1, 1999) (on file with the North Carolina Law Review) (recording an attorney's advice to the directors to be sure they record any objections or questions in the corporate minutes).

277. *See, e.g.*, Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (June 1, 2000) (on file with the North Carolina Law Review) (presenting the board with a proposed budget for the 2000–2001 fiscal year).

278. *See, e.g.*, Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Jan. 4, 2001) (on file with the North Carolina Law Review) (presenting the board a revised 2000–2001 fiscal year budget).

279. *See, e.g.*, Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Mar. 2, 2000) (on file with the North Carolina Law Review) (presenting the board with a quarterly financial update).

confusing and opaque, particularly if one were trying to determine exactly how much revenue was going to NHA.<sup>280</sup>

For example, in the early years of NHA's operations in North Carolina, its normal financial report consisted of a statement of revenues and expenses that included an expense line item identified as "Purchased Management Services – National Heritage Academies."<sup>281</sup> A reasonable director reading that report would assume that line was the total amount that NHA charged for the various administrative services it provided. If the director were aware that NHA was also the school's landlord,<sup>282</sup> he would rightly assume that money was also going to NHA. Most of the other categories in the report were self-explanatory, such as salaries and benefits for teachers.

But as time went on, and as total revenues at the NHA-managed schools grew to many millions, the financial reports became increasingly convoluted as the number of budget line items multiplied and their descriptors grew increasingly vague. By July of 2001, the budgets included the category "Central Services,"<sup>283</sup> which gave rise to the subcategories "Data Processing," "Staff/Personnel Services," and "Other Central Services."<sup>284</sup> There also appeared a category named "Business Support Services," which included "Fiscal Services" and "Internal Services."<sup>285</sup> By the mid-2000s, the reports contained so many vague line items that an outside observer would have little idea what the money was actually being spent on, and a nonprofit director examining the same documents would be in the same position unless she asked aggressive clarifying questions.<sup>286</sup> And yet, there is no evidence that directors asked any such questions.<sup>287</sup>

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280. See Wang II, *supra* note 255 (arguing it is hard for charter school boards to follow the money when nearly all of it goes into the accounts of a private company).

281. See, e.g., Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Aug. 12, 1999) (on file with the North Carolina Law Review) (referring to the \$197,293 allocated to purchased management services).

282. See *infra* note 293 and accompanying text.

283. See, e.g., Revised Budget for 2001–2002, Greensboro Acad. Bd. of Dirs. (June 6, 2002) (on file with the North Carolina Law Review) (including Central Services in the Expenditures column).

284. See, e.g., Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (May 15, 2002) (on file with the North Carolina Law Review).

285. See, e.g., *id.*

286. Eventually, NHA's Director of Accounting began circulating a memorandum with each financial report that purported to explain the budget line items. See, e.g., Board Meeting Minutes, Forsyth Acad. Bd. of Dirs. (May 8, 2007) (on file with the North Carolina Law Review) (including an explanatory memo by Kathy Schmidt, Director of School Accounting). However, they shed little light on what the money was actually being spent on and no light on how the charges were determined. *Id.* For example, the memo

Even if a director were able to discover precise meanings for these fuzzy line items, she would have little or no idea how NHA arrived at the reported figures. As indicated earlier, all of the nonprofit organization's revenues are swept into NHA's bank account, and the only expense information the board gets back is whatever NHA tells it the goods and services cost. A director could ask NHA to explain how much the company actually spent for a particular good or service, or even how much profit NHA reaped as a result of a particular transaction, but NHA would be under no obligation, contractual or legal, to reveal that information. As mentioned earlier, obtaining a clear picture of where the money is going is further hampered by the fact that the management contract explicitly permits NHA to attribute the expenses of shared back-office services to any of its schools, so long as the attribution is "reasonable."<sup>288</sup>

In the years' worth of meeting minutes and budget reports I reviewed, a troubling pattern emerged. In the spring, NHA would present to the school's board a projected budget for the following school year. Once the school year began, NHA would introduce amended budgets, and, more often than not, report an increase in total revenues as a result of healthier-than-projected student enrollment or the acquisition of grants. Along with the increase in revenue, NHA's amended budgets would show significant increases in the dollar figures attached to the fuzzy expense line items. So, for example, in the amended budget, the "Internal Services" line item might increase by tens of thousands of dollars. In most such cases, it was impossible to conjure an explanation of why an increase in total revenues would lead to a big increase in spending on "Internal Services."<sup>289</sup>

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explains "State and Federal Relations" as "central services for governmental relations, partner services, and intervention services." *Id.* The category "Business and Internal Services" is explained as being "for finance, payroll, compliance monitoring, facilities management, and real estate acquisition." *Id.* Query why a school that is forking over a huge monthly lease payment to NHA should be billed for "real estate acquisition." "Central Services" is explained as "central services for people services, people development, technology, and research and development." *Id.*

287. See Wang II, *supra* note 255 (arguing that state auditors in New York examined the finances of an NHA-managed school in Buffalo and determined that although the school's board approved overall budgets, it appeared to accept the company's numbers with few questions so that its signoff was "essentially meaningless").

288. See *supra* note 266 and accompanying text.

289. See, e.g., Board Meeting Minutes, Forsyth Acad. Bd. of Dirs. (May 8, 2007) (on file with the North Carolina Law Review) (presenting a final revised budget for the 2006–2007 fiscal year that raised estimated total revenues from \$4.8 million to \$5.2 million and

Perhaps there are legitimate business justifications, but if so, nothing on the record indicates that NHA shared these justifications with the nonprofit directors. Of course, the vague line items and frequently shifting dollar amounts also would be consistent with NHA's desire to create "slush" categories that, in combination with its flexibility to attribute shared expenses to whichever schools it chooses, would permit it to mask situations where it was amassing eye-popping profits.<sup>290</sup>

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distributed the excess through various vague administrative budget categories); Board Meeting Minutes, Forsyth Acad. Bd. of Dirs. (Nov. 14, 2006) (on file with the North Carolina Law Review) (presenting a revised projected budget for the 2006–2007 fiscal year with total revenue increasing from approximately \$4.4 million to approximately \$4.8 million and increases in several of the vague administrative categories including "Central Support Services" alone increasing from \$161,000 to \$195,000); Board Meeting Minutes, Forsyth Acad. Bd. of Dirs. (Jan. 4, 2001) (on file with the North Carolina Law Review) (presenting a revised budget for the 2000–2001 fiscal year in which total revenue increased from approximately \$2.6 million to approximately \$2.9 million and the excess was distributed through various vague administrative budget categories); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (May 13, 2014) (on file with the North Carolina Law Review) (presenting financial reports indicating that the final amended budget for the 2013–2014 fiscal year increased from \$5.5 million to \$5.7 million and that the excess funds were spent on, among other things, "Central Services"); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Apr. 5, 2005) (on file with the North Carolina Law Review) (including a year-end budget report for the 2004–2005 fiscal year, showing that the original projected budget was approximately \$4.3 million; by year-end, actual revenues were approximately \$4.5 million. The excess was sprinkled through "Executive Administration," "Business Administration," and "Central Administration," and "Central Administration" alone increased, for no obvious reason, by \$36,000); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Dec. 7, 2004) (on file with the North Carolina Law Review) (revealing year-end spending figures substantially above the projected amounts and where the extra funds were distributed into budget categories such as "Executive Administration" and "Central Services"); Board Meeting Minutes, PreEminent Charter Acad. Bd. of Dirs. (Nov. 14, 2011) (on file with the North Carolina Law Review) (presenting the board with an amended budget that increased projected revenue by approximately \$155,000 and distributed the excess through various vague administrative categories); Board Meeting Minutes, Queens Grant Cmty. Sch. Bd. of Dirs. (May 15, 2008) (on file with the North Carolina Law Review) (presenting a final revised budget for the 2007–2008 fiscal year revealing that projected revenue increased from approximately \$5.3 million to approximately \$5.7 million and that several vague administrative categories increased markedly, including an increase of more than \$50,000 for "Central Services").

290. In recent years, NHA has begun "invoicing" its schools for the services it provides. I can only assume they have taken to this practice in hopes of cementing the perception that the school is paying for concrete and valuable services that NHA is providing. However, as far as I can tell, those invoices serve no useful purpose. They simply parrot the line items, including the same apparent slush categories, contained in the financial reports. *See, e.g.*, Board Meeting Minutes, Greensboro Acad. Bd. Of Dirs. (Sept. 10, 2013) (on file with the North Carolina Law Review) (including three invoices from the NHA).

To take one illustrative example, board minutes from the November 5, 2002, meeting at Greensboro Academy reveal that NHA presented a revised budget for the 2002–2003 school year that increased projections of total revenue by approximately \$142,000 as a result of greater than expected enrollment.<sup>291</sup> The remainder of the budget projection sprinkles most of that windfall through various vague line items so that “Executive Administration” increased by \$63,000, “Business Support Services” increased by \$19,000, and the illusive “Central Services” increased by \$34,000, all without any explanation of why those expense categories would increase significantly as a result of the addition of a relative handful of students.<sup>292</sup>

One budget item that would be difficult for NHA to obscure is lease payments to NHA in exchange for providing school facilities. From the perspective of NHA, the lease arrangements constitute what my friends from the entrepreneurial business sector would refer to as a brilliant “real estate play” because there is virtually no way for NHA to lose. Technically, NHA leases the facilities from its own property development affiliate, Charter Development Company, LLC, and then subleases the property to the charter school.<sup>293</sup> The terms of the lease make clear that if the school loses its charter<sup>294</sup> or for any reason terminates the management agreement, NHA takes back the real estate along with everything attached to it.<sup>295</sup> According to other lease terms, the tenant—meaning the charter school nonprofit—pays all maintenance,<sup>296</sup> repair,<sup>297</sup> utilities,<sup>298</sup> taxes,<sup>299</sup> and insurance.<sup>300</sup> The terms that require the tenant to pay expenses are, of

291. Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Nov. 5, 2002) (on file with the North Carolina Law Review).

292. *See id.*; *see also* Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Sept. 10, 2013) (on file with the North Carolina Law Review) (reflecting a similar increase in projected total revenues and corresponding increases in expenses attributed to vague line items); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Apr. 5, 2005) (on file with the North Carolina Law Review) (similar); Board Meeting Minutes, Greensboro Acad. Bd. of Dirs. (Dec. 7, 2004) (on file with the North Carolina Law Review) (similar).

293. *See, e.g.*, Greensboro Acad. Lease Agreement, *supra* note 262, at Recitals para. A (on file with the North Carolina Law Review) (indicating that Charter Development Company, LLC is the property’s owner and that it has entered into a Master Lease with NHA).

294. *See id.* at para. 13.1.E.

295. *Id.* at para. 13.2.

296. *Id.* at para. 9.1.

297. *Id.* at para. 8.1.

298. *Id.* at para. 5.1.

299. *Id.* at para. 6.1.

300. *Id.* at para. 7.1.

course, conceptually confusing since in fact NHA takes all of the nonprofit's revenue before the school ever gets its hands on it, and pays itself<sup>301</sup>—in effect taking money out of one of its pockets and shifting it to another—for rent, maintenance, and all other expenses.<sup>302</sup> Under another provision of the lease, the nonprofit also agrees that if NHA makes capital improvements to the property, it may raise the rent to compensate itself.<sup>303</sup> Thus, under the terms of the lease between NHA and its charter schools, there is virtually no way for NHA to lose money. It takes the nonprofit organization's money, pays itself whatever it wants in rent (thereby eliminating any debt it incurred in constructing the facility), and reimburses itself for any and all real-estate-related expenses.

Not surprisingly, available evidence points toward significant real-estate-related profits. In some instances, the schools pay rents approaching \$1 million per year.<sup>304</sup> When maintenance and other expenses are added on, the charges can be upwards of \$1.2 million per year.<sup>305</sup> Tax records for PreEminent Charter Academy, a NHA-managed school in North Carolina, furnish evidence of generous profits reaped by NHA. Those records indicate that the land for the school was purchased from the previous owners in 2002 for \$180,000.<sup>306</sup> A construction permit was issued for the same parcel in June 2002 for a building valued at \$2.9 million, which apparently was completed in April 2003.<sup>307</sup> In 2003, PreEminent Charter School

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301. Another provision of the lease is fascinatingly convoluted. Paragraph 2.1 states that “[p]ursuant to the terms of the Management Agreement between [NHA] and Tenant[], NHA is providing the leased facilities and Tenant has assigned all costs to be paid by Tenant under the terms of this Lease to NHA, which assignment shall remain in effect . . . .” *Id.* at para. 2.1. If my law students turned in such a provision, I would tell them to rewrite it in comprehensible language. What it appears to mean is that the parties acknowledge that the Management Agreement between the charter school and NHA provides NHA with the right to use the nonprofit's money to pay itself for providing the real estate.

302. *See supra* notes 260–61 and accompanying text (explaining “sweeps” contracts).

303. Greensboro Acad. Lease Agreement, *supra* note 262, at para. 3.5.

304. *See, e.g.*, Ninth Amendment to Lease Agreement Between National Heritage Academy, Inc. and Greensboro Academy, Inc. (May 22, 2008) (on file with the North Carolina Law Review) (establishing annual rent for the school facility at \$977,760).

305. *See, e.g.*, Greensboro Academy, Proposed Initial Budget for the 2008–2009 School Year, (Apr. 14, 2008) (on file with the North Carolina Law Review) (showing a projected annual expense of \$1.34 million for Operations and Maintenance).

306. *Account Summary for 3815 Rock Quarry Road*, WAKE COUNTY REAL EST. DATA, <http://services.wakegov.com/realestate/Account.asp?id=0067665&stype=owner&owner=BTYP-Charter+Development+Company&spg=1> (last visited Aug. 17, 2015).

307. *Assessment Notes for 3815 Rock Quarry Road*, WAKE COUNTY REAL EST. DATA, <http://services.wakegov.com/realestate/Notes.asp?id=0067665&cd=01&loc=3815++ROCK>

began paying annual rent for that facility at the level of \$813,120.<sup>308</sup> For several years thereafter, annual rent settled at approximately \$772,000,<sup>309</sup> but, effective in 2013, rose to \$814,560.<sup>310</sup> All this time, of course, NHA was exercising its right under the lease and management agreements to pay itself for providing all maintenance and repair.<sup>311</sup> Given the apparently modest cost of acquisition and construction and the large, ongoing rent payments from PreEminent to NHA, which appear to have totaled more than \$6 million over a period of eight years, one could reasonably speculate that NHA's real estate development costs were long ago paid off, that the stream of payments now constitutes healthy profit, and that there is no end in sight for the good times that NHA is enjoying.

This was the conclusion of a Detroit Free Press investigative series that focused on NHA's business practices.<sup>312</sup> According to the report, NHA typically fronts the money to build or renovate charter schools and rapidly recoups its investment through rents charged to the schools.<sup>313</sup> Those rents, invariably paid with a secure stream of public dollars, generally do not decrease even after NHA has recovered its initial investment.<sup>314</sup> To compound the problem, there is evidence that the monthly and yearly rents NHA charges are, at least in some instances, above market rate.<sup>315</sup>

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+QUARRY+RD&des=PROP+OF+CHARTER+DEVELOPMENT+CO+LLC+BM2002-01374&pin=1722460857 (last visited Aug. 17, 2015).

308. First Amendment to Lease Agreement Between National Heritage Academy, Inc. and PreEminent Charter School (May 12, 2004) (on file with the North Carolina Law Review).

309. Fourth Amendment to Lease Agreement Between National Heritage Academy and PreEminent Charter School (May 22, 2006) (on file with the North Carolina Law Review) (establishing annual rent at \$772,640).

310. Tenth Amendment to Lease Agreement Between National Heritage Academy and PreEminent Charter School (effective July 1, 2013) (on file with the North Carolina Law Review).

311. See *supra* notes 296–304 and accompanying text.

312. Dixon, *supra* note 253.

313. *Id.*

314. *Id.*

315. Martha Thierry, *Graphic: National Heritage Academy's Rents Exceed What Most Experts Say are Reasonable*, DETROIT FREE PRESS (June 21, 2014), <http://archive.freep.com/interactive/article/20140622/NEWS06/140621006/Graphic-National-Heritage-Academy-s-rents-exceed-what-most-experts-say-reasonable>; see also Wang II, *supra* note 255 (arguing that New York state auditors concluded that Brooklyn Excelsior Charter School, run by NHA, was paying above-market rent for its building).



## 2. Description of Financial and Management Practices of Schools Managed by Charter Schools USA

In some respects, CSUSA's management practices are similar to those of NHA. Based on my review of their meeting minutes, boards of directors meet regularly, receive updates on school performance and parent satisfaction, and approve policies and procedures drafted or amended by CSUSA staff. The boards have at least some involvement in hiring decisions, though they do not receive detailed information about job applicants, and their approvals often appear perfunctory. To a greater extent than the NHA or RBA schools, the boards at CSUSA-managed schools appear to benefit from independent legal advice.<sup>316</sup> As with NHA, the schools' directors receive periodic financial reports that could only be fully understood if board members were asking detailed questions. As with NHA, there is little evidence that directors ever pose such questions.

However, CSUSA's standard management contract is different from NHA's in several respects and in general is less controlling. To begin, it is not a sweeps contract,<sup>317</sup> although CSUSA does have unfettered access to the nonprofit schools' checking accounts.<sup>318</sup> CSUSA takes a flat management fee defined as fifteen percent of total revenues.<sup>319</sup> Also unlike NHA, the contract provides that at least some equipment and materials purchased for the school become the school's property, meaning the school would be left with some education-related equipment if the management contract were terminated.<sup>320</sup> The contract's default and termination provisions are more stringent than those of NHA.<sup>321</sup> Instead of granting either party the right to terminate the management contract upon ninety-days' notice (a right that, as explained above, is largely illusory because of the "Grinch" problem),<sup>322</sup> CSUSA's contract carefully defines default,

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316. See, e.g., Board Meeting Minutes, Cabarrus Charter Acad. Bd. of Dirs. (Jan. 22, 2014) (on file with the North Carolina Law Review) (indicating the school's lawyer recommended changes to the real estate development contract between the school and CSUSA's real estate affiliate, Red Apple Development).

317. See *supra* notes 260–61 and accompanying text.

318. Charter Management Agreement Between Charter School USA and the North Carolina Charter Education Foundation, Inc. art. V, para. A (Oct. 1, 2012) [hereinafter Charter Mgmt. Agreement Between Charter Sch. USA and the N.C. Charter Educ. Found., Inc.] (on file with the North Carolina Law Review).

319. *Id.* at art. V, para. E.

320. *Id.* at art. III, para. D.

321. See *id.* at art. VII.

322. See *supra* notes 253–54 and accompanying text.

requires an opportunity to cure, and permits termination only if those terms are not met.<sup>323</sup>

When applying for new North Carolina charters, CSUSA has addressed state regulators' concerns about the control it wields over schools by repeating the mantra that their relationship is subject to a "performance based contract."<sup>324</sup> By this they mean that the management contract requires them to perform a broad array of services, and that the contract's default provisions permit the schools to terminate the contracts if those obligations are not met. For two reasons, this answer is dissatisfying. First, it is true of most contracts that performance is due from both parties and that one may terminate if the other fails to perform. There is nothing special or different about these CSUSA management contracts. Second, the contract's definition of nonperformance is narrow and does not include language that would permit the schools to simply decide that they were not getting a good enough deal and wanted to look elsewhere for their management functions.<sup>325</sup>

From a nonprofit law perspective, the most troubling aspect of CSUSA's relationship with its schools involves real estate. CSUSA's real estate development affiliate, Red Apple Development, owns the North Carolina charter schools' facilities, and there is at least some evidence to indicate that CSUSA attempted to conceal from state and federal authorities the fact that the schools' EMO would also, in effect, be their landlord. For example, when the nonprofit corporation responsible for Cabarrus Charter Academy filed its IRS Form 1023 seeking 501(c)(3) status, it responded to a question about real estate development by saying "[i]t is anticipated that a school [facility] will be constructed and financed by a private developer on the site, who will in turn lease the facility to the Academy."<sup>326</sup> In response to another specific question about how Cabarrus would ensure that its facility would be developed under a market-rate, arms-

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323. Charter Mgmt. Agreement Between Charter Sch. USA and the N.C. Charter Educ. Found., Inc., *supra* note 318, at art. VII.

324. Charter School Application for 2013: Cabarrus Charter Academy, N.C. Charter Educ. Found., Inc. 41 (Apr. 12, 2012) [hereinafter Cabarrus Charter Application], available at <http://www.ncpublicschools.org/docs/charterschools/resources/application/2014apps/cabarruscharter.pdf>.

325. Charter Mgmt. Agreement Between Charter Sch. USA and the N.C. Charter Educ. Found., Inc., *supra* note 318, at art. VII.

326. The N.C. Charter Found., Inc., IRS Form 1023, Application for Recognition of Exemption pt. IV (OMB No. 1545-0056) (2013).

length transaction, the school simply did not answer, though the Form's instructions clearly required it to do so.<sup>327</sup>

Similarly, in Cabarrus Charter Academy's charter application to the North Carolina Office of Charter Schools, it responded to a question about school facilities by claiming that a "private developer" would construct the buildings and that the name of the landlord was unknown.<sup>328</sup> Worse yet, the North Carolina charter application filed by Cardinal Charter Academy explicitly claimed that the facility would not be owned by the management company and that it would be constructed and financed by a "third party" who would rent it to the school.<sup>329</sup> It further asserted that the lease agreement would be "independent of the Board's management agreement."<sup>330</sup> These responses are at best disingenuous, since the questions clearly are intended to ferret out whether the management company is also going to be the landlord, and that all of CSUSA's charter-related real estate transactions followed an established pattern that result in its affiliate, Red Apple, leasing the properties to the schools,<sup>331</sup> and reaping what appears to be very healthy returns.<sup>332</sup> It may also be

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327. *See id.* at pt. VIII, Question 7a & Sched. B, § 1, Question 7 (asking "will persons other than your employees or volunteers develop your facilities" and requiring a detailed explanation if the answer is yes).

328. Cabarrus Charter Application, *supra* note 324, at 149.

329. NC Charter School Application for School Opening 2014: Cardinal Charter Academy, N.C. Charter Educ. Found., Inc. 28 (Mar. 1, 2013) (on file with the North Carolina Law Review).

330. *Id.*

331. The pattern is that the schools' initial real estate development is undertaken by Ryan Companies, US, which is a large international construction firm. *See generally* RYAN COMPANIES, <http://www.ryancompanies.com/> (last visited Aug. 17, 2015). Ryan enters into a twenty-year commercial "triple net lease" (meaning, in essence, the tenant pays all expenses) with the charter-holding nonprofit. *See Lease Agreement by and Between Ryan Co. US, Inc. and North Carolina Charter Education Foundation, Inc.* art. II, para. 3–4; art. III para. 2; art. V; art. VI, para. 1 (Nov. 23, 2012) (on file with the North Carolina Law Review). Soon thereafter, Ryan conveys the property to Red Apple Development, which steps into Ryan's shoes and assumes the lease. *Our Schools*, RED APPLE DEV., <http://www.redappledevelopment.com/our-schools/> (last visited Aug. 17, 2015). There could be perfectly valid business justifications for structuring the transaction in this way, but, from the perspective of CSUSA, it also has the advantageous result of making its assertions about a "third party" developing and renting school facilities to the charter schools at least technically true. It also means that neither Red Apple's nor CSUSA's name is associated with the schools' real estate development during the crucial period when they are being closely examined by state and federal regulators.

332. *See Cabarrus Charter Application*, *supra* note 324, at 138 (projecting that Cabarrus would be paying \$1.9 million in rent/lease expenses by year five of its existence); *see also Lease Agreement by and Between Ryan Co. US, Inc. and North Carolina Charter Education Foundation, Inc.*, *supra* note 331, at art. II (showing a schedule of rent payments that begins modestly at \$80,000 per year, but ends in year twenty with annual payments of \$1.8 million).

worth pointing out that none of the documents that CSUSA provided to me revealed the role played by Red Apple. The only reason I discovered Red Apple's involvement is that I checked the real estate records in the relevant counties.

Given this information about CSUSA's involvement with charter school real estate, it should not be surprising that others have focused on the same issue and have found what they consider to be improper behavior. One recent investigative report in Florida, where CSUSA is headquartered and runs numerous charter schools, alleged that CSUSA earns tens of millions of dollars a year by acting as, essentially, a real estate firm.<sup>333</sup> An investigation by the Florida League of Women Voters came to a similar conclusion.<sup>334</sup>

To summarize, NHA, by means of the management contracts it enters into with North Carolina nonprofit charter-holding corporations, sweeps millions of public dollars into its own coffers every year and reveals little about precisely how that money is spent and how much of it goes to corporate profits rather than the provision of public education. Under the terms of their lease arrangements with charter schools, both NHA and CSUSA (as well as RBA) engage in what appear to be highly lucrative real estate deals that permit them to obtain ownership of valuable properties using public funds and charge charter-holding nonprofits rent (possibly above-market rent) long after their acquisition-related debts are paid off. Because the management organizations own the schools' real estate (and, in the case of RBA and NHA, practically everything else the schools need to function), the schools' boards of directors are virtually powerless to fire them or otherwise alter the relationships.

### 3. The Application of Nonprofit Legal Doctrines to Schools Managed by National Heritage Academies and Charter Schools USA

Although the foregoing discussion may make some readers queasy—particularly if they pay taxes in North Carolina—NHA and CSUSA doubtless would respond that nothing in the state's charter school legislation explicitly prohibits such management and financial practices. They would be correct, but they would also be ignoring the

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333. Jeff Bryant, *Charter Schools Don't Need an Ad Campaign; They Need Regulation*, CAMPAIGN FOR AMERICA'S FUTURE (Aug. 28, 2014), <http://ourfuture.org/20140828/charter-schools-dont-need-an-ad-campaign-they-need-regulation>; see also Noah Pransky, *Charter Schools Making Big Profits for Private Companies*, WTSP (Tampa, Fla. Aug. 2, 2014), <http://www.wtsp.com/story/news/investigations/2014/08/21/charter-school-profits-on-real-estate/14420317/> (describing the business model of CSUSA).

334. See LEAGUE OF WOMEN VOTERS OF FLA., *supra* note 9, at 7–12.

application of state and federal nonprofit law to charter schools and their management. This discussion begins by specifying which of the nonprofit legal doctrines discussed in Part I do not apply to NHA's and CSUSA's management practices.

Private inurement does not apply because that doctrine forbids nonprofit corporate *insiders* from lining their pockets with charitable assets.<sup>335</sup> Among the schools managed by NHA and CSUSA, there may be diversion of charitable assets taking place, but there is no evidence that corporate insiders, such as nonprofit board members, are skimming money themselves or colluding with others to do so. Similarly, because neither NHA nor CSUSA is a DQP<sup>336</sup> with respect to the charter-holding nonprofits, they will not be subject to intermediate sanctions penalties.<sup>337</sup> Finally, the state law fiduciary duty of loyalty covers much the same ground as private inurement and intermediate sanctions, and for similar reasons, is inapplicable here. That, however, still leaves the private benefit doctrine (along with its close cousin the operational test) and the state law fiduciary duties of obedience and care.

a. Operational Test and Private Benefit Doctrine

NHA- and CSUSA-managed schools should be concerned about failing the IRS's operational test and thereby losing their 501(c)(3) tax-exempt status. The test asks whether more than an insubstantial part of a given charity's activities are in furtherance of something other than its charitable purpose.<sup>338</sup> Because the operational test, like many IRS doctrines, is guided by a vague "all the factors" analysis,<sup>339</sup> it is difficult to determine in advance whether the NHA- and CSUSA-managed schools have crossed the line into noncompliance, but there is sufficient evidence available to assume that both are in peril. Given that NHA manages its schools under a sweeps contract and thereby

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335. See *supra* Section II.B.1.a.

336. See *supra* Section II.B.1.a.

337. As discussed in Section III.A.2.a, RBA and its for-profit affiliate companies can be considered DQPs in relation to its charter-holding nonprofit due to Mitchell's involvement with the nonprofit's board of directors. In contrast, no individuals on NHA's or CSUSA's boards are owners of the for-profit companies that manage them. Once again, however, I would invite others to make the argument that the for-profit management companies, especially NHA, should qualify as insiders by virtue of their comprehensive contractual control over the schools they manage. Such an argument, while intriguing, is beyond the scope of this Article.

338. See *supra* Section II.B.2.

339. See HOPKINS, *supra* note 74, at 79 (arguing that the operational test question of whether an organization has a substantial nonexempt purpose is a question of fact based on all the available evidence).

controls virtually every aspect of their operations and finances, given that its financial reports are opaque and that it is virtually impossible to determine how much of the public's money is being diverted into corporate profits, and given that there is little evidence that the schools' boards of directors have bothered to investigate that question, there are grounds to believe that a substantial portion of the nonprofit schools' activities and resources are being devoted to noncharitable purposes—namely generating profits for NHA. The case is weaker for CSUSA-managed schools, both because their boards appear to be more engaged and because the evidence of troubling profiteering is confined to the realm of real estate.<sup>340</sup>

This group of charter schools and their for-profit management companies should also be concerned about the application of the IRS's private benefit doctrine, which, similar to the operational test, asks whether a charitable organization's benefits are more than incidentally flowing to private individuals outside the charitable class.<sup>341</sup> There is ample evidence indicating that the financial benefits flowing to CSUSA, and especially to NHA, are quantitatively substantial.<sup>342</sup> NHA, through its management contracts and leases, maintains almost complete control over its schools' operations and finances. The "Grinch" clauses<sup>343</sup> render it virtually certain that the boards will not challenge NHA's control no matter what percentage of the charitable dollars it takes for itself. Although no one will know how extensive NHA's profits are until and unless legal authorities compel them to disclose that information, the schools' budgets indicate that NHA's management fee combined with its real estate profits amounts to millions of dollars annually.<sup>344</sup> In the case of CSUSA, there is at least some evidence to indicate that it is receiving substantial economic benefits as a result of the real estate its affiliate leases to the schools it manages.<sup>345</sup> As discussed in Section II.B.2.b, above, demonstrating a private benefit violation does not require proof that benefits are flowing to outsiders at above-market rates, only that they are substantial and that they are ending up with individuals who are not part of the charitable class.<sup>346</sup>

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340. See *supra* notes 317–31 and accompanying text.

341. See *supra* Section II.B.2.b.

342. See *supra* note 175 and accompanying text (discussing quantitative and qualitative substantial benefit).

343. See *supra* notes 253–54 and accompanying text.

344. See *supra* notes 290–312 and accompanying text.

345. See *supra* notes 326–34 and accompanying text.

346. See *supra* Section II.B.2.b.

Likewise, there is evidence to prove that the benefits flowing to CSUSA, and especially to NHA, are qualitatively substantial. As in the credit-counseling cases discussed in Section II.B.2.b, the nonprofit charter-holding organizations have off-loaded substantial portions of their operations to for-profit providers when there is no reason to believe that the schools could not provide those services themselves in a more efficient and cost-effective manner.<sup>347</sup> In the case of NHA, with its sweeps contracts, one could argue that the boards handed the schools' keys over to the for-profit company. The fact that there are successful independently managed charter schools all across the state belies any contention that these charter schools would not be able to fulfill their charitable missions without resorting to the for-profit organizations' services, and that alone is sufficient to demonstrate that the benefits are qualitatively substantial.<sup>348</sup>

b. Fiduciary Duties of Obedience and Care

In addition to potentially engaging in violations of federal nonprofit law, the NHA- and CSUSA-managed charters are in peril of violating state fiduciary duties applicable in the nonprofit sphere. Although it is unlikely that the North Carolina Office of the Attorney General will intervene to enforce the fiduciary duties of the boards of directors of the nonprofit charter-holding schools,<sup>349</sup> there are

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347. See *supra* Section II.B.2.b.

348. In the case of NHA, it is clear that the IRS had similar private-benefit concerns to those expressed here. After at least two of its schools, Greensboro Academy and PreEminent Charter Academy, had already begun operations, the IRS rejected their initial 501(c)(3) applications, largely on private-benefit grounds. Based on the evidence, the IRS feared that NHA would retain complete control over the schools and use that control to funnel large profits to itself. The schools hired a high-priced Washington, D.C. law firm, which produced point-by-point, extensive written rebuttals of the IRS's legal arguments. In addition to the exhaustive (and exhausting) legal arguments, NHA offered to amend certain aspects of its management contract, including a clause that permitted NHA to terminate the contract (and leave the schools with nothing) if the schools' boards interfered with NHA hiring decisions. As often happens when the IRS is confronted with the prospect of pitched legal battle, it folded and granted 501(c)(3) status to the schools. Compare Letter from Gerald V. Sack, IRS Manager of Exempt Org. Technical Grp. 4, to Greensboro Acad. (Apr. 18, 2002) (on file with the North Carolina Law Review) (rejecting Greensboro Academy's 501(c)(3) application largely on private benefit grounds), with Letter from Celia Roady, Attorney Representing Greensboro Acad., to the IRS (July 22, 2002) (on file with the North Carolina Law Review) (appealing the rejection and offering to amend certain terms of the management contract), and Letter from Gerald V Sack, IRS Manager of Exempt Org. Technical Grp. 4, to Greensboro Acad. (Aug. 7, 2002) (on file with the North Carolina Law Review) (reversing the IRS's earlier denial and granting 501(c)(3) status). This Article suggests that, more than a decade later, the IRS should take another close look.

349. See *supra* Section II.A.4 (discussing the North Carolina Attorney General's lack of enforcement resources).

grounds to believe that directors at NHA and CSUSA are not fulfilling them.

The duty of obedience requires directors to ensure that a charitable organization's resources are being used to serve its charitable purposes.<sup>350</sup> Among other things, directors should engage in reasonable comparative shopping to ensure that the organization's money is being spent with reasonable efficiency.<sup>351</sup> If close examination reveals that board members are permitting significant charitable assets—assets that might otherwise be used to improve or expand charitable and educational services—to be diverted to unreasonable corporate profits, the directors could be violating their duty of obedience. For the schools described in this second category, there is no evidence that directors are engaging in any sort of comparative shopping, and there is at least some evidence that financial resources are being unreasonably diverted from serving the schools' charitable and educational missions.

Likewise, the schools' governance practices should be carefully examined to determine if directors are adhering to their duty of care. Directors at schools managed by NHA and CSUSA receive reasonably detailed information about policies and procedures, student achievement, parent satisfaction, personnel matters, and other operational matters. They also receive periodic financial reports that provide them up-to-date information about the schools' gross revenues and spending. However, particularly in the case of NHA-managed schools, directors have no way of determining how NHA formulates the expense figures that it reports and whether they are accurate and reasonable. Nor do the directors have any way of knowing what percentage of the schools' resources is being taken as profit by NHA. The duty of care would require them to at least ask.<sup>352</sup>

*C. Third Category: Charter Schools that Appear to Comply with Nonprofit Law*

Because rectitude is less interesting than controversy, this discussion will be brief. In general, governance practices at the independently managed charter schools in my sample,<sup>353</sup> as well as the schools managed by KIPP, a nonprofit management company, were thorough, correct, and in compliance with nonprofit law. Their boards

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350. See *supra* Section II.A.3.

351. See *supra* Section II.A.3.

352. See *supra* Section II.A.1 (explaining the fiduciary duty of care).

353. These schools are: Socrates Academy, Tiller School, and Woods Charter School.



met regularly and kept reasonably detailed minutes.<sup>354</sup> They tended to have more directors than the boards of EMO-managed schools,<sup>355</sup> and they enhanced the governance capabilities of the directors by creating numerous board committees.<sup>356</sup> Some organize themselves as membership nonprofit corporations, which usually means that students' parents vote each year to decide who serves on the board of directors.<sup>357</sup> Many of the organizations were models of transparency, posting their board meeting minutes<sup>358</sup> and other significant corporate documents on their websites.<sup>359</sup> A review of the minutes showed that directors were privy to detailed financial information about the organizations,<sup>360</sup> regularly assessed multiple bids for vendors'

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354. See, e.g., Board Meeting Minutes, Socrates Acad. Bd. of Dirs. (Sept. 11, 2013) (on file with the North Carolina Law Review) (discussing governance details and breaking financial reports down into granular categories).

355. Compare *Board of Directors*, SOCRATES ACAD., <http://www.socratesacademy.us/~socrates/index.php/about-socrates/board-of-directors> (last visited Aug. 17, 2015) (listing eight board members), and *Tiller School Board of Directors*, TILLER SCH., <http://tillerschool.org/board-of-directors/> (last visited Aug. 17, 2015) (listing twelve board members), with *Our School Board*, GREENSBORO ACAD., <https://www.nhaschools.com/schools/greensboro/en/About-Us/Pages/Our-School-Board.aspx> (last visited Aug. 17, 2015) (listing five board members).

356. See, e.g., Board Meeting Minutes, KIPP Gaston Coll. Preparatory Bd. of Dirs. (Sept. 18, 2013) (referring to reports by the Finance and Governance committees); *Board of Directors Committees*, SOCRATES ACAD., <http://www.socratesacademy.us/~socrates/index.php/about-socrates/board-of-directors/board-committees> (last visited Aug. 17, 2015) (listing sixteen separate board committees).

357. See, e.g., BYLAWS OF THE TILLER SCHOOL OF CARTERET COUNTY, available at [http://tillerschool.org/wp-content/uploads/2014/03/Tiller\\_School\\_Bylaws-Revised-December-2013.pdf](http://tillerschool.org/wp-content/uploads/2014/03/Tiller_School_Bylaws-Revised-December-2013.pdf) (last revised Dec. 2013) (describing the school's membership structure).

358. See, e.g., *School Board*, WOODS CHARTER SCH., <http://www.woodscharter.org/school-board> (last visited Aug. 17, 2015) (posting board meeting minutes, bylaws, and other corporate documents).

359. See, e.g., Board Meeting Minutes, Socrates Acad. Bd. of Dirs. (Nov. 13, 2013) (on file with the North Carolina Law Review); *Tiller Community Portal*, TILLER SCH., <http://tillerschool.org/community-portal/> (last visited Aug. 21, 2015) (posting corporate bylaws and other key documents on their website).

360. See, e.g., Board Meeting Minutes, Socrates Acad. Bd. of Dirs. (June 11, 2014), available at [https://www.socratesacademy.us/images/pdf\\_files/meeting\\_minutes/June\\_14\\_BOD\\_Binder-for\\_web.pdf](https://www.socratesacademy.us/images/pdf_files/meeting_minutes/June_14_BOD_Binder-for_web.pdf) (reporting budget figures that detail salaries of each employee).

services,<sup>361</sup> and properly identified and scrutinized potential conflicts of interest.<sup>362</sup>

In short, a nonprofit law assessment of the governance practices of schools falling into this third category leaves little to object to.

#### CONCLUSION

This Article raises serious questions about whether certain North Carolina charter schools, which by statute must be nonprofit organizations, are complying with state and federal nonprofit law. The most troubling indications of noncompliance arise among schools that are managed under contract by for-profit companies, also referred to as EMOs.

Evidence points to nonprofit law violations among the cluster of schools managed by Roger Bacon Academy (“RBA”). Federal charity regulators should investigate in particular whether these RBA-managed charter schools are violating the private inurement and intermediate sanctions doctrines. State charity regulators should determine whether two former directors (one of whom still serves as the board’s secretary) who are affiliated with RBA violated their fiduciary duties of loyalty toward the schools by engaging in self-dealing transactions. State authorities should also ask whether the disinterested directors violated their duty of care by permitting what arguably were conflict-of-interest transactions.

Charity regulators should also closely scrutinize the nonprofit law compliance of two additional clusters of North Carolina EMO-managed charter schools—one managed by National Heritage Academies (“NHA”) and the other by Charter Schools USA (“CSUSA”). Based on an assessment of years’ worth of board meeting minutes and financial reports of NHA-managed schools, it is arguable that NHA has perfected the art of appearing to furnish nonprofit schools’ board members with detailed information about governance and finances while in fact masking how the charitable dollars are being spent and how much money NHA is taking as profit. My analysis shows little if any evidence that board members at the

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361. See, e.g., Board Meeting Minutes, Socrates Acad. Bd. of Dirs. (Feb. 12, 2014) (on file with the North Carolina Law Review) (discussing bids for work on the school’s HVAC system); Board Meeting Minutes, Socrates Acad. Bd. of Dirs. (Oct. 9, 2013) (on file with the North Carolina Law Review) (comparing the costs and benefits of various purchasing cards).

362. See, e.g., Board Meeting Minutes, KIPP Gaston Coll. Preparatory Bd. of Dirs. (Aug. 21, 2013) (on file with the North Carolina Law Review) (discussing one board member’s possible conflict of interest).

nonprofit charter schools have taken the necessary steps to investigate whether the charitable dollars flowing through their schools are being spent with reasonable efficiency. The fact that NHA and its corporate affiliate own practically everything the schools need to function, including their school facilities, renders it doubtful that the nonprofit board members could terminate their management agreements even if they did peek into NHA's financial black box, discover that they were getting a bad deal, and decide to make changes. Concerning CSUSA, the worst that can be said is that it collaborates with its affiliate, Red Apple Development, to make its charter schools the subjects of lucrative "real estate plays." Combined, these facts point toward NHA- and CSUSA-managed schools' possible violations of the federal operational test and private benefit doctrines and the North Carolina fiduciary duties of loyalty and care.

To these potential nonprofit law violations, it is an insufficient answer that the charter school students do well on standardized tests and that parents generally are satisfied with the schools' performance. In all transactions between charitable organizations and for-profit companies, the tax-paying public is a silent third party.<sup>363</sup> The citizenry subsidizes contributions to charitable organizations in the form of charitable tax deductions. In the case of charter school funds, the connection to the tax-paying public is even more immediate, since the schools' revenues are comprised almost entirely of tax revenues. Tax-paying citizens rely on charity regulators—particularly the IRS and the state attorneys general—to look out for their interests in the charitable sector and to be sure that their money—the public's money—is not being diverted from charitable purposes into nonincidental private profits.<sup>364</sup> Given the evidence that has come to

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363. See Laura B. Chisolm, *Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework*, 6 *NONPROFIT MGMT. & LEADERSHIP* 141, 147–48 (1995) (arguing charities' duties are to the public and attorneys general and the IRS are responsible for protecting the public's interests); Alice M. Maples, *State Attorney General Oversight of Nonprofit Healthcare Corporations: Have We Reached an Ideological Impasse?*, 37 *CUMB. L. REV.* 235, 237 (2007) (arguing that one of state attorneys generals' most important roles is guarding the public's interests in charitable assets).

364. See FISHMAN & SCHWARZ, *supra* note 77, at 226 (arguing that state attorneys general represent the interests of the public by promoting accountability by charitable organizations); N.C. *GUIDEBOOK FOR DIRECTORS*, *supra* note 79, at 32 (arguing that North Carolina nonprofit law empowers the Attorney General of North Carolina to enforce compliance with nonprofit norms); James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 *EMORY L.J.* 617, 639 (1985) (arguing that, because most attorneys general devote meager resources to the task of protecting the public's interest in charitable organizations, the IRS has become the de

light as a result of this and other inquiries, it is arguable that neither the IRS nor the North Carolina Attorney General is fulfilling this vitally important monitoring and enforcement function.

This Article has illuminated questions and potential problems with the nonprofit legal compliance of certain North Carolina charter schools and called upon charity regulators to investigate whether the law is indeed being broken. The question remains whether, in addition to investigating these specific incidents, lawmakers should consider regulatory changes to ensure that such problems do not arise in the future. The matter of regulating for-profit corporations' involvement in charter schools will become all the more urgent when, in the near future, for-profit managed virtual charter schools make their debut in North Carolina.<sup>365</sup>

A thorough exploration of necessary charter school legal and regulatory reforms is beyond the scope of this Article, but it concludes by offering a few modest suggestions. The North Carolina charter statute should be amended to:

- (1) bar individuals associated with EMOs from serving as directors or officers of any charter school their EMOs manage;
- (2) prohibit sweeps contracts;
- (3) require each EMO to report regularly and in detail how much money each school has paid to it and its affiliates;
- (4) require all charter schools to post on their websites board minutes, board packets (including financial reports), important corporate documents (articles of incorporation, bylaws, and conflict-of-interest policies), Forms 1023, and recent Forms 990;
- (5) prohibit or restrict agreements between charter schools and their EMOs' affiliates for the provision of real and

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facto watchdog); Lloyd Hitoshi Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 480–81 (2010) (arguing that in recent years the IRS has assumed additional responsibility for protecting the public's interests in charities).

365. See Lynn Bonner, *Two Virtual Charter Schools on Track for North Carolina*, NEWS & OBSERVER (Raleigh Dec. 17, 2014), <http://www.newsobserver.com/2014/12/17/4411642/two-virtual-charter-schools-on.html> (reporting the approval of two virtual charter schools, one to be managed by K12, a for-profit company whose management practices have been controversial in other states); see also ANNENBERG INST. FOR SCH. REFORM, *supra* note 16, at 11 (claiming that the academic track record of the online charter school industry is “abysmal” and that there are widespread accounts of profiteering and fraud).

personal property to avoid the “Grinch” problem whereby schools are stripped bare if they decide they are dissatisfied with the EMO’s performance; and

- (6) require charter school boards to have no fewer than nine members (to avoid situations where three members of a five-person board are required to review and approve massive amounts of material at a given board meeting).

While state regulators are working out the details of those reforms, the IRS can focus on clarifying the private benefit doctrine as it applies to charter schools. Based on what I have seen in my North Carolina sample, the IRS should begin by drawing a bright line and declaring that the combination of powers wielded by EMOs such as National Heritage Academies—sweeps contracts combined with ownership of practically all real and personal property used by the schools—are flatly prohibited.