

Imagine Schools, Inc.: A Track Record of Diversion of Education Dollars and Conflict of Interest

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This brief examines the contractual relationships between Imagine Schools Imperial Valley (ISIV) and its management organization, Imagine Schools. Analysis of documents provided to the California Department of Education, show that Imagine Schools is extracting a substantial proportion of ISIV's annual revenues through fiscally-unsound contractual arrangements with ISIV for costly management services and facility rental. Conflicts of interest and deceitful, and possibly illegal¹, financial practices define these arrangements. While this brief does not explore the academic performance of ISIV, these arrangements which enable Imagine Schools to divert education funds away from ISIV, may be putting students at serious risk of low quality educational outcomes due to a poorly resourced educational environment.

These serious fiscal and management issues at ISIV discussed in this brief appear to be part of a larger strategy of Imagine Schools to enrich the parent company at the expense of individual schools.² Many Imagine charter schools have come under great scrutiny for these types of fiscally unsound and conflict of interest-ridden arrangements and have been subject to state investigations and legal action. For example, Great Western Academy, an Imagine-affiliated school in Ohio, is currently being investigated by the State Auditor for its real estate contracts.³ In 2012, the Missouri Board of Education shut down six Imagine-affiliated charter schools due to academic and financial issues, including similar questionable financial arrangements that plague ISIV.⁴ As the Missouri Commissioner of Education explained, ““It would be a disservice to the children — and run counter to the mission of the State Board of Education to ensure a quality public education experience for every child — to allow the underperforming and poorly managed Imagine Schools to continue to operate.”⁵ An Imagine-affiliated charter school in Washington DC has also faced investigation, in which findings prompted the district officials to take steps to, among other reforms, tighten standards that charter schools must meet to sign contracts with “related parties.”⁶ Imagine-affiliated schools have also come under scrutiny in Nevada, Florida, Pennsylvania and Indiana for financial mismanagement similar to that of ISIV.⁷

It is incumbent on the California State Board of Education to serve as an effective gatekeeper to prevent fraudulent and deceitful arrangements, such as the transactions that Imagine Schools is known for undertaking and are currently occurring at ISIV. Valuable education dollars should be going to provide California students with rich educational experiences, not lining the pockets of a national management corporation and its real estate subsidiary. This brief summarizes two of the most concerning

¹ Imperial Valley Board of Education's Request for FCMAT Audit of Imagine Schools at Imperial Valley dated March 13, 2018

² Green, Preston and Baker, Bruce D. and Oluwole, Joseph, Are Charter Schools the Second Coming of Enron?: An Examination of the Gatekeepers That Protect against Dangerous Related-Party Transactions in the Charter School Sector (February 27, 2017). Indiana Law Journal, Volume 93, Forthcoming.

³ Catherine Candisky, “Ohio taxpayers paid \$7.7 million to renovate charter-school building valued at \$2.4 million,” The Columbus Dispatch, July 28, 2018.

⁴ Valerie Strauss, “Missouri closing six Imagine charter school campuses,” Washington Post, April 18, 2012.

⁵ Ibid.

⁶ Emma Brown, “D.C. officials seek stronger oversight of charter schools after recent fraud allegations,” Washington Post, June 15, 2014.

⁷ Catherine Candisky, “Charter school's lease deals scrutinized,” The Columbus Dispatch, October 12, 2014.

management problems related to ISIV, it also includes a deeper dive into a number of examples of similar problems at other Imagine-affiliated charter schools across the country.

Issue #1: Schoolhouse Finance LLC, a subsidiary of Imagine Schools, siphons off public dollars through an excessive rental agreement

As discussed in ISIV's "Response to Staff Report and Findings for Denial of Charter Renewal Petition by California Department of Education" dated August 10, 2018 and El Centro Elementary School District's "Request FCMAT Audit of Imagine Schools at Imperial Valley" dated March 13, 2018, it is our understanding that in 2010, Imagine Schools entered into an agreement with SASD Development Group to finance the purchase of El Centro Mall and convert a former department store into a school setting. On March 26, 2010, a company called Imagine 26 Partners LLC finalized the purchase of the property for \$3,100,000. Imagine 26 Partners LLC immediately entered into a lease with Schoolhouse Finance LLC, which is a wholly owned for-profit subsidiary of Imagine Schools. This agreement requires Schoolhouse Finance LLC to pay between \$775,000 and \$1,365,059 per year for rent. Schoolhouse Finance then subleased the property to ISIV for \$449,999.99 for 11 months, and then entered into a 20-year sublease the following years which requires ISIV to pay between \$949,900 and \$1,673,367.22, depending on the year of operation as base rent, as well as pay for all repairs, maintenance, taxes, and insurance, also known as a "triple net lease." Triple net leases are very costly to schools leasing facilities, and can create significant budget deficiencies if revenues and growth projections do not grow over time. These large rent payments siphon off public funds to Imagine Schools, via its subsidiary, Schoolhouse Finance LLC, which comes at the expense of the educational environment for the students.

As of February 2018, ISIV paid \$7,905,532 in rent even though the facility was purchased for \$3,100,000. Over the life of the 20-year lease, ISIV, if it remains in operation, is slated to pay an astronomical \$28,049,523 in rent, with no option to own the facility at the end of the term. Imagine Schools claims that Schoolhouse Finance LLC is charging ISIV market rate rent at \$2.21 per square foot which, as the company recently explained, "is within local comparison of \$1.75 to \$2.50 per sq. ft. for finished space."⁸ The lease agreements between the City of El Centro and Imagine 26 Partners for other space in the same exact building tell a very different story. As of last year, before the property was gifted to the city, the rent charged for other space in the same building was between \$0.85 to \$0.96 per square foot depending on the year of the lease agreement, significantly less than what Schoolhouse Finance LLC charged ISIV for its space in the same building during the same time frame.⁹ It appears that Schoolhouse Finance LLC is charging more than twice the rate for the charter school space as was recently charged for other space in the same facility.

It is important to note that this leasing arrangement has been plagued with conflict of interest problems from the very beginning. Both the 11-month sublease and the subsequent 20-year sublease were signed by Paul Stich on behalf of ISIV and Barry Sharp on behalf of Schoolhouse Finance LLC. Barry Sharp currently services as CEO of Imagine Schools. At the time that the leasing contracts were signed, Paul Stich was a direct subordinate of Barry Sharp.¹⁰ As such, he should not have signed independently for ISIV, as it constitutes an obvious and serious conflict of interest between ISIV and Imagine Schools.

⁸ Imagine Schools Response to Questions Posed by CDE Staff on August 15, 2018, dated August 17, 2018.

⁹ City of El Centro RESOLUTION NO. 11-144 and RESOLUTION NO. 11-145 approved on November 1, 2011. Rent per square foot calculation derived from dividing monthly lease payment at various points throughout contract term with square footage of rented space.

¹⁰ Imperial Valley Board of Education's Request for FCMAT Audit of Imagine Schools at Imperial Valley dated March 13, 2018

Nonetheless, he signed the agreements and also acted to approve the 20-year sublease at the ISIV board meeting on February 24, 2011.¹¹

This real-estate model has been repeatedly used by Imagine Schools and is well-documented in a recent paper published in the *Indiana Law Journal*, aptly titled, “Are Charter Schools the Second Coming of Enron?: An Examination of the Gatekeepers That Protect against Dangerous Related-Party Transactions in the Charter School Sector.”¹² This paper examines how some charter school officials have engaged in Enron-like related-party transactions and highlights Imagine Schools as an example of these practices. Specifically, the article discusses Imagine School’s real estate arrangements in three Missouri charter schools where Schoolhouse Finance LLC purchased property in collaboration with a real estate investment firm. Schoolhouse Finance made improvements to the building and then flipped the building to the real estate investment firm, which then leased the property back to Schoolhouse Finance LLC. Schoolhouse Finance LLC then subleased the property to the Imagine-affiliated charter school at a markup. These arrangements resulted in documented lease payments that constituted a much larger percentage of the school’s revenue than other charter schools in the area.¹³

In *Renaissance Academy for Math & Science of Missouri v. Imagine Schools*, a federal district court ruled that the educational management organization committed a breach of fiduciary duty by causing the charter school governing board to enter into unreasonable lease agreements with Schoolhouse Finance LLC. The court noted that these leases “clearly constituted self-dealing,” because Imagine Schools was the sole owner of Schoolhouse Finance LLC and benefited from the excessive leases. As the court explained, Imagine Schools, as a fiduciary, had not informed the school board how the lease might benefit the school, or how it might harm the school, as the high cost of the lease payments “would result in lower-than-average instructional expenditures, including textbooks, classroom supplies, and teacher salaries, which was exactly what happened.”¹⁴ Imagine Schools was ordered to pay \$935,400 in damages for the breach of fiduciary duty.¹⁵

Great Western Academy, an Imagine school in Ohio, is currently being investigated by the State Auditor for a similar deal. Schoolhouse Finance LLC leases the school from a third-party and financed renovations to the building for \$4.4 million. In the past ten years under the lease between Schoolhouse Finance LLC and Great Western Academy, the school has paid \$7.7 million in rent payments; \$3.3 million above the amount spent on the renovations. Rent payments have cost the school almost \$1 million some years. Moreover, the county auditor valued the property at \$2.4 million in 2017, meaning that the school has already paid more than three times the building’s value in rent payments. The Columbus Dispatch reports that the auditor has questions about rent payments being excessive and contracts benefiting a company connected with Imagine Schools. As a spokesperson for the auditor explained, “This office has made multiple referrals to federal authorities for related-party transactions involving

¹¹ ISIV Board Meeting Minutes, February 24, 2011 contained in Exhibit 10 in Imperial Valley Board of Education’s Request for FCMAT Audit of Imagine Schools at Imperial Valley dated March 13, 2018

¹² Green, Preston and Baker, Bruce D. and Oluwole, Joseph, *Are Charter Schools the Second Coming of Enron?: An Examination of the Gatekeepers That Protect against Dangerous Related-Party Transactions in the Charter School Sector* (February 27, 2017). *Indiana Law Journal*, Volume 93, Forthcoming.

¹³ *Ibid.*

¹⁴ *Ibid.*

¹⁵ Stefanie Dion Jones, “A Lesson From Enron: Charter Schools Need More Oversight,” *UConn Today*, March 6, 2017.

Schoolhouse Finance and their affiliated schools in 2014 and 2016. And last year, Auditor Yost directed his staff to conduct a comprehensive review of these arrangements.”¹⁶

Issue #2: ISIV’s affiliate agreement with Imagine Schools directs around 15% of ISIV’s valuable public dollars away from the school.

ISIV entered into an affiliate agreement with Imagine Schools on July 27, 2010.¹⁷ Per this agreement, Imagine Schools provides management services to the school. In exchange, this agreement requires ISIV to pay a significant percentage of its revenue, derived of public dollars. This fee is comprised of three categories, including:¹⁸

1) Indirect Cost Allocation: ISIV is required to pay a percentage of its annual allocation from the state to ISNP for centralized administrative and financial support services. The cost has historically been set at 12%, but the agreement allows Imagine Schools to determine the percentage it will take from ISIV’s budget each year. ISIV has budgeted \$951,550 for its indirect cost allocation to Imagine Schools for this current school year.¹⁹ It is important to note that there is little accountability built into this contract structure. Imagine Schools’ fee increases as enrollment in the school increases, but there are no mechanisms to ensure that Imagine Schools is providing adequate services or a sufficient level of services. Moreover, this agreement remains in effect for the entire time that ISIV is a charter school, giving the school little to no recourse in the case they are unhappy with the services they receive from Imagine Schools.

2) Loss Mitigation Fee: ISIV is required to pay between 1% and 3%, depending on how many years the school has been in operation, of its per-pupil funding to Imagine Schools for potential loss mitigation assistance, in which Imagine Schools can provide financial assistance to the school if it is experiencing low cash flow. Essentially, Imagine School’s loss mitigation fund is a reserve fund for the charter school. However, instead of ISIV holding on to these reserves in their accounts and earning interest on the funds, Imagine Schools is able to pocket the school’s money into their own accounts, along with any interest that would be earned. If the charter school needs to access these funds due to low cash flow, Imagine Schools can ensure that its outstanding expenses to the school get paid before any other expenses. Moreover, the agreement allows Imagine Schools to charge interest to the charter school on funds that the school borrows from the loss mitigation fund.²⁰ The result is a one-sided arrangement that allows Imagine Schools to skim extra revenue from the charter school – Imagine Schools deposits reserve funds for ISIV into their own account, earns interest on those funds that the school would otherwise be earning, and then lends the money back to the school and earns additional interest on that

¹⁶ Catherine Candisky, “Ohio taxpayers paid \$7.7 million to renovate charter-school building valued at \$2.4 million,” The Columbus Dispatch, July 28, 2018.

¹⁷ Affiliate Agreement between ISIV and ISNP dated July 27, 2010, included as Exhibit 3 in Imperial Valley Board of Education’s Request for FCMAT Audit of Imagine Schools at Imperial Valley dated March 13, 2018 and obtained at: <https://www.cde.ca.gov/be/cc/cs/accsnotice081218.asp>.

¹⁸ Ibid.

¹⁹ El Centro Elementary School District Board Action Denying Renewal of Imagine Schools at Imperial Valley dated February 16, 2018 obtained at <https://www.cde.ca.gov/be/cc/cs/documents/accs-aug18item03a7.pdf>

²⁰ ISIV to ISNP payment information from Affiliate Agreement between ISIV and ISNP dated July 27, 2010, included as Exhibit 3 in Imperial Valley Board of Education’s Request for FCMAT Audit of Imagine Schools at Imperial Valley dated March 13, 2018 and obtained at: <https://www.cde.ca.gov/be/cc/cs/accsnotice081218.asp>.

loan, all at the expense of the charter school. ISIV has budgeted 2% of its budget, \$158,588, for Imagine School's loss mitigation fund for this current school year.²¹

3) Direct Expenses: ISIV is required to reimburse Imagine Schools for any expenses incurred associated with loaned employees from Imagine Schools, including salaries, benefits, bonuses, etc. It is unclear how many loaned employees ISIV is currently paying for.

In all, the agreement requires ISIV to send around 15% of its annual revenues to ISNP and pay for any Imagine Schools employees that are "loaned" to ISIV. As noted above, ISIV is subject to the terms of this affiliate agreement for the entire time the charter school is in operation, allowing ISIV and its board very little control and leverage over the school's management. The board has very little ability to exercise due diligence with regard to its management contract under the current arrangement with Imagine Schools. The payment structure provides no incentive for ISNP to provide high-quality management services, since it is paid the same percentage regardless of its performance. There are no performance metrics or other incentives tied to Imagine Schools' payment, which would allow ISIV to attempt to remedy any potential deficiencies or problems with Imagine Schools' management services.

Other Imagine-affiliated schools around the country have been subject to similar affiliate agreements with Imagine Schools, and have found these agreements to be expensive and limiting in terms of how much control the local board has over the management of the school. A 2010 New York Times exposé detailed management agreements that appeared to be similar to the ISIV contract with Imagine Schools, which required schools to pay Imagine Schools similar payments in similar amounts.²² What is clear from the article is that these management arrangements with Imagine-affiliated schools have been in use by Imagine Schools for years, and that the same issues present in the ISIV arrangement have plagued other Imagine campuses with many negative consequences. For example, Imagine-affiliated charter schools in Georgia,²³ New York,²⁴ and Florida²⁵ have fought to end their management agreements with Imagine Schools, in large part due to the pressure the excessive management fees have put on the schools' budgets and the perceived lack of value from the management contract. As someone who worked for the schools and was familiar with the break-up between the Bronx Academy of Promise Charter School and Imagine Schools explained, "It was rather baffling, but as a management company, they weren't providing any management services."²⁶

Furthermore, some Imagine-affiliated charter school boards and parents have felt like they have very little control over the school. While the scope of affiliate agreement is for management services, some schools have felt like the control that Imagine Schools exerts over its charter schools takes away local decision-making ability. For example, parents at the former Imagine-affiliated school, Imagine of the Valle in Clark County, Nevada reported feeling like they had very little voice in how the school was run. In one parent's words, "They [Imagine Schools] have the power, they hold the strings."²⁷ This

²¹ El Centro Elementary School District Board Action Denying Renewal of Imagine Schools at Imperial Valley dated February 16, 2018 obtained at <https://www.cde.ca.gov/be/cc/cs/documents/accs-aug18item03a7.pdf>

²² Stephanie Strom, "For School Company, Issues of Money and Control," New York Times, April 23, 2010.

²³ Ibid.

²⁴ Ibid.

²⁵ Gabrielle Russon, "North Port charter school breaks off from Imagine Schools," Sarasota Herald-Tribute, February 19, 2013.

²⁶ Stephanie Strom, "For School Company, Issues of Money and Control," New York Times, April 23, 2010.

²⁷ Emily Richmond, "Charter school families find they have little say over company," Las Vegas Sun, April 2, 2010.

arrangement became even more problematic when the state announced it was cutting public education funding by 6.9% to help close a massive budget gap. Despite the decrease in funding for the charter school, Imagine Schools would not renegotiate their costly management fee. The company even proposed moving the school to a more expensive facility, which would direct even more scarce dollars into Imagine Schools coffers, via its subsidiary, Schoolhouse Finance LLC. As the Las Vegas Sun News explained, parents learned the hard way that once they had accepted Imagine Schools' proposal to form a charter school that it would operate, they were mostly helpless in controlling costs.²⁸

The critical issues discussed in this brief should give any body charged with oversight of charter schools serious concern. Allowing ISIV, an Imagine Schools-affiliated charter school, to continue to operate will continue to harm taxpayers and students, who are at the mercy of a company with a questionable track record rife with diversion of education dollars and conflicts of interest.

²⁸ Emily Richmond, "Charter school families find they have little say over company," Las Vegas Sun, April 2, 2010.