



Dave Yost • Auditor of State

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Dave Yost • Auditor of State

To the Ohio Board of Education, Superintendent DeMaria, Office of Community Schools, and the General Assembly:

The Auditor of State (AOS) conducted a review, under our Ohio Revised Code 117.11 authority, of the community school facility procurement market; the period reviewed extended from 2005 through 2018. Emphasis during this examination was focused in two parts, 1) theory; including an analysis of the current legal structure in Ohio, funding options available to community schools to obtain facilities, and issues commonly encountered by community schools in their quest to obtain facilities in Ohio and other states;. And 2) an analysis of how the current Ohio community school facility market operates in practice through a detailed review of individual schools. Items reviewed included lease agreements, historical facility information and research into possible relationships between the entities involved in those transactions.

This report, which is being provided to the General Assembly and referred to the Ohio Ethics Commission, provides an overview of funding sources and methods of finance available to Ohio community schools for facility procurement, the current legal structure and other barriers or restrictions placed on community schools which affect their ability to obtain facilities, and the current condition of the community school facility market. To provide insight into the environment in Ohio in which community schools currently operate to meet their facility financing needs a detailed review was performed over the schools operating under the oversight of three different community school management companies. ODE and the General Assembly are encouraged to use the observations and results of this report as a resource to improve current Ohio law as it applies to community schools.

This examination was not a financial or performance audit, for which the objectives would be vastly different. It was therefore not within the scope of work to conduct a comprehensive examination of those community schools included in the review, to issue citations for any issues, failures, or noncompliance identified during the review, or to in anyway otherwise opine on the individual operations of the schools reviewed.

The majority of information included in this report was derived from public records and cooperation with other government agencies both inside and outside of Ohio. AOS reviewed both current and formerly operating community schools for 17 Concept managed community schools (of 18 currently operating in Ohio); 13 Imagine Schools, Inc. managed community schools (of 15 currently operating in Ohio); and eight National Heritage Academies managed community schools (of 10 currently operating in Ohio).

To the Ohio Board of Education, Superintendent DeMaria, Office of Community Schools, and the General Assembly
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Sincerely,

A handwritten signature in black ink that reads "Dave Yost". The signature is written in a cursive style with a large, looping initial "D".

Dave Yost
Auditor of State

Introduction

This study of community-school facility leases was prompted by a complaint filed with the Ohio Auditor of State alleging that complex lease agreements entered into by some community schools involved with management companies are resulting in excessive lease payments, diverting public dollars away from educating students and into the pockets of private companies and the individuals who run them.

The aim of this study is to delineate the legal and financial circumstances faced by community schools in their efforts to acquire facilities, to detail the means used to make these acquisitions, and to test specific examples for legality and reasonableness, and to identify any potential conflicts of interest.

The study found that community schools face unique constraints on their ability to acquire and pay for facilities on their own, and some have resorted to methods that deserve scrutiny by the state legislature. The study looks to the Federal General Services Administration Acquisition Manual as an example of a system designed to help public entities acquire facilities at competitive rates.

Background

Community schools, also known as charter schools, are tasked with educating students in the same sense as traditional school districts. However, community schools operate as independent public entities funded by taxpayer dollars. Community schools are typically opened in urban and low performing districts to help fulfill the education needs of students in certain areas identified as deficient or to provide certain services and specialized education to a specific subset of students such as children with physical or learning disabilities.

Though school districts can, and some have, created community schools of their own, oversight and management is typically run independent of traditional school districts. Each school has its own governing board of education that oversees the operations and integrity of the school. At the discretion of the school's board of education, operations can be managed internally, or may be contracted to a management company. Management companies can offer a variety of services and, depending on the provider, may be offered a la carte or as a full-service package. The degree of involvement a management company has in the operations of a school can vary significantly. A management company may assume anywhere from partial to full management of the school's day-to-day operations depending on the management agreement.

Management companies utilized for a limited number of services may manage a portion of the school's operations such as accounting or payroll processing. Full-service management companies however will do everything for the school from establishing the school's curriculum, hiring teachers and principals, handling human resources and marketing, and managing fiscal duties. In some cases, as much as 98 percent of a school's public funding may be paid to a full-service management company in return for its services in managing the school.

The schools reviewed in this examination operated under management companies that handled the vast majority of the school operations and played a large role in how the school's facilities were acquired.

Methodology

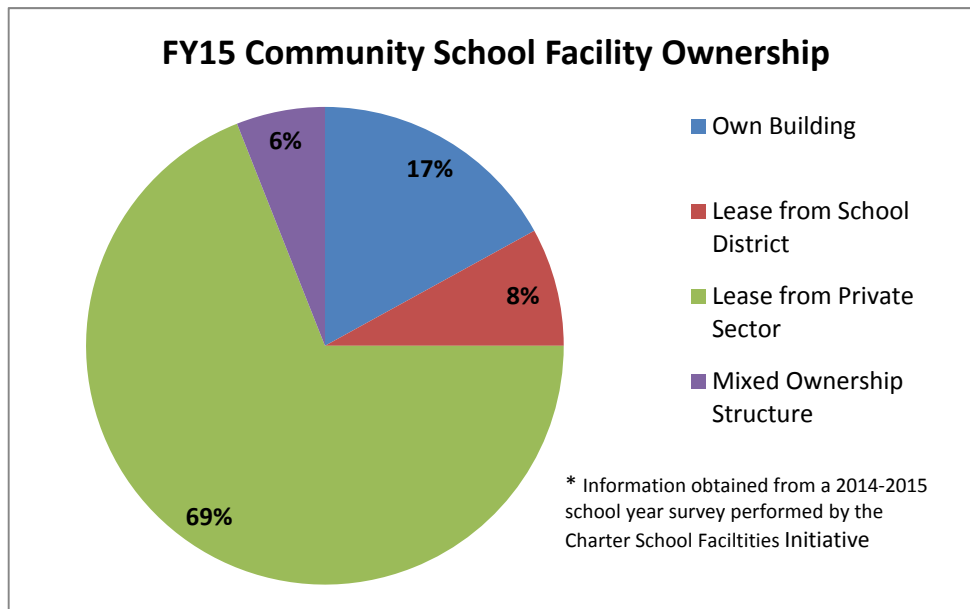
Auditors examined Ohio laws, sources of funds available to Ohio community schools in the procurement of facilities, and other circumstances affecting community schools in relation to their facilities, and compared these with approaches used in other states. Auditors also examined the methods used by management companies to procure facilities, including an analysis of working relationships within these transactions, with an emphasis on the legality of these relationships.

Three management companies were selected as the focus for the analysis by the AOS Public Integrity Assurance Team. Lease agreements and historical financial data were examined for the schools operating under these three management companies, in addition to a sample of six other randomly selected community schools in Ohio to use as a base comparison for judgments. Historical lease information was scheduled for each year of operations, including amounts paid, relationships between lessees, lessors, and property owners, lease stipulations, percentages of operating revenues and expenditures consumed by lease payments, and any other data needed to analyze the schools operated by each management company.

AOS staff worked with personnel from the Real Estate division of the Ohio Department of Administrative Services to gain an understanding of market lease rates in the areas surrounding the schools. This allowed a comparison of average market lease rates for comparable facilities surrounding the schools to rates being paid by these community schools.

Finally, auditors made recommendations based on the results of the examination.

Community School Property Ownership Structure in Ohio



Due to difficulties community schools often face in obtaining financing or grants for the purchase or construction of a facility, leasing is the most commonly used option. In a study performed by the Charter

School Facilities Initiative¹ in 2017 over the 2014-2015 school year, 69 percent of community schools in Ohio leased facilities from private parties and 8 percent leased facilities from local districts. Ohio community schools that had ownership or partial ownership of their facilities comprise only 23 percent of those surveyed. Purchasing property is typically only a viable option for community schools that are well-established and able to give lenders assurance that they will be able to make loan payments over the entire life of the term, or are able to obtain grant assistance from sources such as the Ohio Community School Facilities Grant.

In Ohio, community school facilities are most commonly leased from the private sector. Whereas some facilities are already designed as schools, these properties are not always readily available. Of the schools reviewed as part of this analysis, many were in buildings that were not originally designed to house students, such as office buildings, car dealerships, and retail storefronts. Others were in former parochial schools and privately owned former school-district facilities.

Facilities not originally built as schools can require significant renovations for school use. With growth and expansion, these issues can become an increasingly evident and for successful schools may necessitate additional renovations to create gymnasiums, kitchens, large cafeteria spaces, and outdoor/athletic spaces. The party responsible for absorbing the cost of these building renovations both initially and overtime is dependent on the lease terms and willingness of the parties involved.

The limited resources available and the considerable expense of buying real estate prohibit most new community schools from purchasing facilities. The challenge of operating a community school is evident in the number of schools that have closed since the passage of House Bill 215 in 1997 which allowed for the establishment of a pilot community school program in Lucas County and the subsequent passage of House Bill 282 in 1999 which expanded the pilot program to other areas across the state. Of the approximately 601 community schools that have opened in Ohio since 1997, 260 have closed, 136 of these voluntarily. The remainder closed because of noncompliance, poor performance, or simply ceasing operations. Regardless of the reason for closure, financial viability was a problem for 105 schools.² School districts that operated community schools also experienced hardship, with 66 closed schools. This correlates to over 43% closure rate for community schools. The rate of community school failures increases the level of risk for stakeholders, making the difficult task of securing funding even harder.

State Law and the Effects on Ohio Community School Facility Procurement

Laws governing community schools at the state level are generally unique to each state. These state laws directly affect school funding and operation structures. In addition to Ohio, community school laws were researched for California, Indiana, Florida, Massachusetts, and New York to gain an understanding of where Ohio community school laws stand in comparison.

Several issues come into play when understanding the methods used to finance community school facilities. While some exist by virtue of current law, the availability of capital can be a primary problem for many new schools and even those that have been in existence for several years. From the risk of closure, to new legal hurdles and financial obstacles, community schools face a variety of challenges in obtaining proper facilities. These issues have led to the development of new markets and sources of cash.

¹ Charter School Facilities Initiative is a national project developed by the Colorado League of Charter Schools. Their mission is to inform the public of policies and practices currently in place through their nationwide research about charter school facilities and their associated costs.

² See Exhibit B – December 2017

Contract Bidding Process and Exceptions

ORC 3313.46 requires all projects for the construction, repair, enlargement, improvement, or demolition of school buildings which exceed \$50,000 must be publicly bid. This chapter of the ORC applies to all school district boards of education, however does not apply to community schools or their governing boards. There are currently no Ohio laws in place which require community schools to bid such contracts.

Community school sponsors, which are required by the Ohio Department of Education (ODE), act as an additional level of oversight to monitor community school compliance throughout the year. The sponsorship agreement entered into by each school and their sponsor can, at the sponsor's discretion, stipulate additional rules a school must abide by beyond what is required by law. These rules can include required bidding procedures, among other things. Such rules are however discretionary and therefore the majority of sponsors currently operating in Ohio do not require their schools to implement bidding procedures.

The Right of First Refusal

Lack of adequate facilities and efforts by school districts to prevent charter schools from employing unused district school buildings is an issue faced by community schools in acquiring facilities. Under Ohio law, community schools have the right of first refusal for conventional school buildings that have been unused for at least two years. Ohio Revised Code §3313.411 stipulates that, with exceptions, school districts are required to offer any unused school facilities for lease or sale to the governing authorities of community schools, boards of trustees of any college-preparatory boarding schools, and the governing bodies of any STEM schools that are within the district. These entities have 60 days to make an offer. In addition, priority is given to high-performing community schools within the district. The first entity to make an offer is entitled to buy or lease the property at fair market value.

Indiana has a similar law, with an additional requirement that school districts provide to the State Board of Education a listing of properties that have not been used for two years, and for the Board to publish a list of these properties (Indiana Code §20-26-7-1). Similar laws exist in Arizona (Arizona Revised Statutes §15-189,) South Carolina (South Carolina Code of Laws §59-40-170) and Tennessee (Tenn. Code Ann. §49-13-136(c)(1)).

Indiana Code §20-26-7-1 requires that if a charter school wants to use a school building on the list, the school district must lease the building for \$1 a year to the charter school, or sell the building for \$1 to the charter school.

In California and New York City, school districts are required to provide charter schools with adequate facilities that are reasonably equivalent to their own, and the districts are allowed only to charge the charter schools a proportionate share of their facility costs. (California Code §47614 and New York Consolidated Laws, Education Law §2853(3)(5)(a-5)(e)). As in many states across the country, Ohio requires traditional school districts disposing of property to first offer these facilities to charter schools to lease or purchase, prior to putting them on the open market. Our research showed mixed findings regarding this practice, with some districts readily complying, and others stretching out the process or refusing to sell these properties. Therefore, simply having the law is no guarantee that a charter will be able to obtain the space. School districts are hesitant to allow charter schools into property they own, and often see charter schools as competition they do not want.

An article in the Columbus Dispatch on November 7, 2017, reported that Columbus City Schools' agreement to sell a vacant property to the Ohio State University had fallen through.

The article reported the board members for the school district wanted to know what would be done with the building, including whether it would become a charter school that could compete with district programs in the neighborhood. As a result, the sales agreement included a final-use clause that was intended to prevent the university from allowing charter schools to use the space. The Columbus City School District held 14 vacant schools and buildings on its books for the 2015-2016 school year.³ The District is working on selling or leasing these facilities and in 2015, sold at least three facilities to community schools, but it is clear this is not always the case.

Problems have occurred elsewhere, too. Prior to June 2012, the Cincinnati City School District was using deed restrictions to limit the ability of charter schools to obtain the facilities by prohibiting the use of the buildings for school purposes. In 2012, the Ohio Supreme Court decided that the inclusion of deed restrictions preventing properties disposed of by the district to be used for school purposes is unenforceable because the restrictions are against public policy.⁴

Ohio is not the only state where school districts fight charter schools moving into district buildings. In a story posted by Detroit's Channel 4 News on December 1, 2017, the Detroit Public Schools Community District blocked a charter school, Detroit Prep, from acquiring a building the school district sold to a private company in 2009. A deed restriction limiting the use of the building was placed by the school district in the original sale to a private entity preventing the sale to Detroit Prep. The Michigan Legislature changed the law to disallow these kinds of deed restrictions and there is a lawsuit seeking to overturn the deed restriction so Detroit Prep can acquire the building. The article quotes Michigan House Reform Committee Representative Tim Kelly as saying: "This is a political fight about charter schools versus traditional schools."⁵

Similar legal battles have occurred in Pennsylvania and Wisconsin. While these battles are under way, charter schools must find other facilities.

Inability to Levy Taxes

Traditional school districts in Ohio are financed by a combination of federal, state, and local funds. Whereas state foundation payments for student enrollment are the same for both traditional and community schools, other sources of revenue may be limited. Factors such as the type of school and the number of students directly influence the sources of funding available at all levels. At the local level, school districts can receive funding from locally levied taxes. These levies can be passed for a variety of purposes such as to fund general operations, facility construction or renovation, and debt issuances.

ORC 3314.08(E) prohibits community schools from levying taxes. As a result, most community schools in Ohio do not receive any local revenues and must rely on federal, state, and private donations to support operations, which includes facility related expenses. Local funding mechanisms commonly used by traditional school districts not directly available to community schools include:

- Property tax revenue, which provides a source of local funding to school districts, can be levied for a variety of purposes; school districts may have multiple levies in place at the same time up to a 10 mill limitation.
- An income tax levy, which imposes a separate percentage tax on the income of individuals that live in the school district, can be levied by traditional school districts.

³ <http://www.dejongrichter.com/ccsoh/wp-content/uploads/sites/5/2016/01/Columbus-City-Schools-Buildings.pdf>

⁴ Cincinnati City School Dist. Bd. of Edn. v. Conners, 132 Ohio St.3d 468, 2012-Ohio-2447

⁵ <https://www.clickondetroit.com/news/detroit-public-schools-community-district-faces-lawsuit-over-abandoned-elementary-school>

Ohio is not different from other states in imposing these restrictions on community schools. While variations were found in the way these laws are structured, none of the other states reviewed allowed community schools to levy taxes.

Inability to Issue Tax Secured Bonds

Bond issuance is a source of funding often used by traditional school districts to fund large projects such as building purchases, construction, and renovation. Maturity of debt issued by school districts is determined based on the estimated useful life, and can extend up to 40 years. General obligation bonds are secured by tax revenues or the passage of a local bond levy which provides the lender assurance that the principal and interest will be paid. Bond interest costs are reduced for districts due to the decreased exposure to risk of default and because they provide tax-exempt revenue for investors.

The restrictions placed on community schools through ORC 3314.08(E) prevent them from issuing these types of bonds, even in instances in which taxes are levied on their behalf. Community schools are further restricted by ORC §3314.08(G)(1)(b), which prohibits the debt term from exceeding 15 years for any loans used to acquire facilities.

Limited Availability of State Sponsored Facility Assistance

The State of Ohio assists with funding new buildings through the Ohio Facilities Construction Commission (OFCC), which offers several programs to assist traditional school districts.⁶ These programs were not set up to provide aid to community schools. Also, ORC 3314.08(E) indirectly prevents community schools from participating in cost sharing programs.

OFCC programs to assist in facility construction and renovation in traditional school districts include:

- The Classroom Facilities Assistance Program (CFAP), which uses assessed property valuation per student to determine the state and local share for a construction project. This is not available to community schools.
- The Alternative Facilities Assistance Program (AFAP), which provides a reduced portion of projected state funds to assist eligible districts in constructing expanding, or renovating classroom facilities. This is not available to community schools.
- The Expedited Local Partnership Program (ELPP) which gives a district not participating in the CFAP the opportunity to move forward with portions of a project that best fit the district's needs at that time. Once the district enters the CFAP, it is given credit toward its required local contribution for the work completed under ELPP. Because CFAP is unavailable to community schools, ELPP also is not available.
- The Exceptional Needs Program (ENP) is a building replacement program that identifies school facilities most in need of replacement, and will provide assistance for replacing the building. This is not available to community schools.

⁶ <http://ofcc.ohio.gov/ServicesPrograms/K-12Schools.aspx>

The primary program is the Classroom Facilities Assistance Program (CFAP). This program established in 1997 funds facilities projects for school districts utilizing a combination of state and local funding based on the assessed property valuation per student in the district. Other programs administered by OFCC, such as the Exceptional Needs Program (ENP), which provides funding to replace buildings that may pose a health risk to students, also are not available to community schools.⁷ School Districts often are required to provide a local share of funding through property and income tax levies, which is not available to Ohio community schools.

Risk of Closure by the Sponsor or Ohio Department of Education

The availability of credit and type of facilities used by community schools are affected by several factors, including the risk of closure. Community schools face the risk of closure for a number of reasons other than financial viability. Ohio Revised Code §3314.35 provides criteria for the permanent closure of community schools, including failure to offer enough grade levels and poor academic performance. Ohio Revised Code §3314.012(B) requires the Ohio Department of Education to issue an annual report card for each school, which includes academic and financial performance. Report cards can be used to prohibit a school from contracting with a new sponsor (Ohio Rev. Code §3314.034(A)(1)) and without a sponsor, the school is effectively shut down.

Aside from mandatory closures of individual schools required by the Ohio Department of Education, ORC §3314.015 requires that the department also provide oversight to sponsors themselves. Further, ORC §3314.015(B)(1)(a) specifically lists poor fiscal management as reason for the Department of Education to intervene and, if other criteria are not met, could result in the Department revoking the sponsor's ability to sponsor schools. The Ohio Department of Education assumes the role of sponsor for the schools that had been operating under the oversight of the revoked sponsor for a maximum of two years. If the school is unable to find a new sponsor in that time, the school must close.

In addition to the risk of losing a sponsor, the initial term of the sponsorship contract is limited by statute (ORC §3314.015(B)(2)) to a maximum of five years. This contract can be renewed as long as the sponsor and the school both meet certain compliance standards. For a new school, however, this limitation has the ability to prevent a school from purchasing its own facilities due to the risk the school might not be able to renew its sponsorship contract.

Current Sources of Community School Facility Funding in Ohio

State Foundation Funding

Ohio law dictates how funding is provided to traditional and community schools. Charter schools are funded on a per pupil formula amount in the same way that traditional school districts receive state funding. In Ohio, part of the formula for per pupil funding includes a portion for facilities funding. Ohio House Bill 64 increased the amount of funding provided to pay for facilities from \$150 per pupil in 2016 to \$200 per pupil in 2017 going forward for brick and mortar schools, while E-schools receive \$25 per pupil.

The amount of foundation funding for facilities is a very small proportion of the total operating revenues received by schools and while helpful, does not cover the total cost of facilities. For many of the schools examined, facility costs took up significant portions of operating revenues.

⁷ <http://ofcc.ohio.gov/ServicesPrograms/K-12Schools/ENP.aspx>

Community Schools Classroom Facilities Grant Program

With the passage of Amended Substitute House Bill 64 in June 2015, Ohio created the Community School Classroom Facilities Grant Program with an initial appropriation of \$25 million. The Community Schools Classroom Facilities Grant Program is available to community schools in Ohio, and operators (school sponsors) currently operating both inside and outside⁸ of Ohio. In order to be eligible for this grant program, the community school or operator must be considered high-performing, as defined by the Ohio Department of Education⁹. In the first round of funding under this grant eight community schools were approved for purchase, construction, and renovation projects totaling \$17,010,826 of which \$6.4 million was disbursed in fiscal year 2017.¹⁰

As of November 2017, 18 schools and 30 operators in Ohio were eligible to participate in the program; No operators from outside of Ohio were determined to be eligible to apply for assistance under this grant.¹¹ After the remaining funds are awarded, without additional appropriations in the future, this program will be of no assistance to community schools in the future.

Philanthropic Donations

Community schools are sometimes supported through philanthropy. Foundations such as the Walton Family Foundation and the Bill and Melinda Gates Foundation provide millions of dollars to charter schools across the country, helping to finance operations and facilities. One group of charter schools that has benefited from philanthropy is the Knowledge is Power Program (KIPP,) which operates 30 schools across the nation, including one in Ohio. The Walton Foundation has provided KIPP schools donations in excess of \$60 million since the program was founded. It was not alone. Several other organizations regularly donate sums in excess of \$1 million each year.¹² For the community schools included in our examination, we did not see evidence that philanthropic sources provided substantial aid, however they are a potential source of funding for charter schools.

Federal Government Bond Assistance

Two types of bonds are available through the federal government. The first of these, Qualified School Construction Bonds, are a type of tax-credit bond intended to allow schools to issue zero interest or low interest bonds for the purpose of constructing facilities. These types of bonds were created during the U.S. recession in 2008 as part of the American Recovery and Reinvestment Act (ARRA) and expired in 2011. No Ohio community schools were able to take advantage of these bonds, and very few could be utilized in other states due to their inability to issue bonds directly. The second type, Qualified Zone Academy Bonds, were created in 1997 and exist to assist schools with renovations and repairs, new equipment, developing challenging curricula, and training quality teachers. To date, this program has not been utilized by any community school in Ohio. These programs were not eligible to be used by community schools in Ohio unless another local government issued them on their behalf. A few states, such as California and Texas, allow charter schools to participate in this program directly, without needing another entity to issue them on the charter schools behalf.

⁸ Ohio Community School Facilities grant assistance funds are to be used for both existing and newly established Ohio community schools established under ORC 3314.01. School sponsors exclusively operating outside of Ohio are eligible, however must submit plans for use of funds on a Ohio community school

⁹ <https://www.legislature.ohio.gov/legislation/legislation-summary?id=GA131-HB-64>

¹⁰ [http://ofcc.ohio.gov/Portals/0/Documents/Resources/Publications/Annual percent20Reports/OFCC_FY2017_Final_111517.pdf](http://ofcc.ohio.gov/Portals/0/Documents/Resources/Publications/Annual%20Reports/OFCC_FY2017_Final_111517.pdf)

¹¹ Data obtained from the Ohio Facilities Construction Commission news and announcements: <http://ofcc.ohio.gov/NewsEvents/NewsReleases/tabid/241/ArticleID/21/Default.aspx>

¹² <http://www.kipp.org/kipp-foundation/kipp-national-partners/kipp-supporters/>

Conduit Bond Issuance

Not-for-profit organizations have been developed with the primary purpose of lobbying for and providing assistance to charter schools. Although schools in Ohio cannot issue bonds directly, other agencies can and sometimes do issue bond financing to assist charter schools with facilities.

Each year there are new not-for-profit organizations and businesses entering the market to provide assistance to charter schools. Complex legal restrictions and financial obstacles which prevent community schools from directly accessing certain financing mechanisms have led enterprising businesses and not for profits to begin investing in community schools by offering alternative facility financing options such as conduit bond issuances, which are now becoming a larger source of funds.

Community school facilities increasingly are being financed with bonded debt. A 2015 study published by Charter School Advisors & Local Initiatives Support Corporation (CSA & LISC) titled *“Charter School Bond Issuance: A Complete History Volume 3”* reports a growing charter school bond market with increases of 40 percent, 18 percent, and 41 percent for 2012, 2013, and 2014, respectively, while the broader tax-exempt bond market during the same period was flat. The report asserts that this “...reflects the increased demand for affordable, long-term charter school facility financing.” Of the 818 transactions the report examines, 41 defaults occurred, a 5 percent default rate. In addition, a full 77 percent of the examined bonds were issued with ratings considered investment grade. Lastly, the report asserts “...that academic quality is the fundamental credit factor in school underwriting.” The reason for this is there is a correlation between low academic performance and default, with lower performing schools having more difficulty maintaining attendance and meeting covenants to continue operation.

Local Government Levy

While community schools themselves may not levy taxes, some states, including Ohio, allow other governmental entities when placing a levy on the ballot to allocate a portion of those levy revenues to community schools in the area.

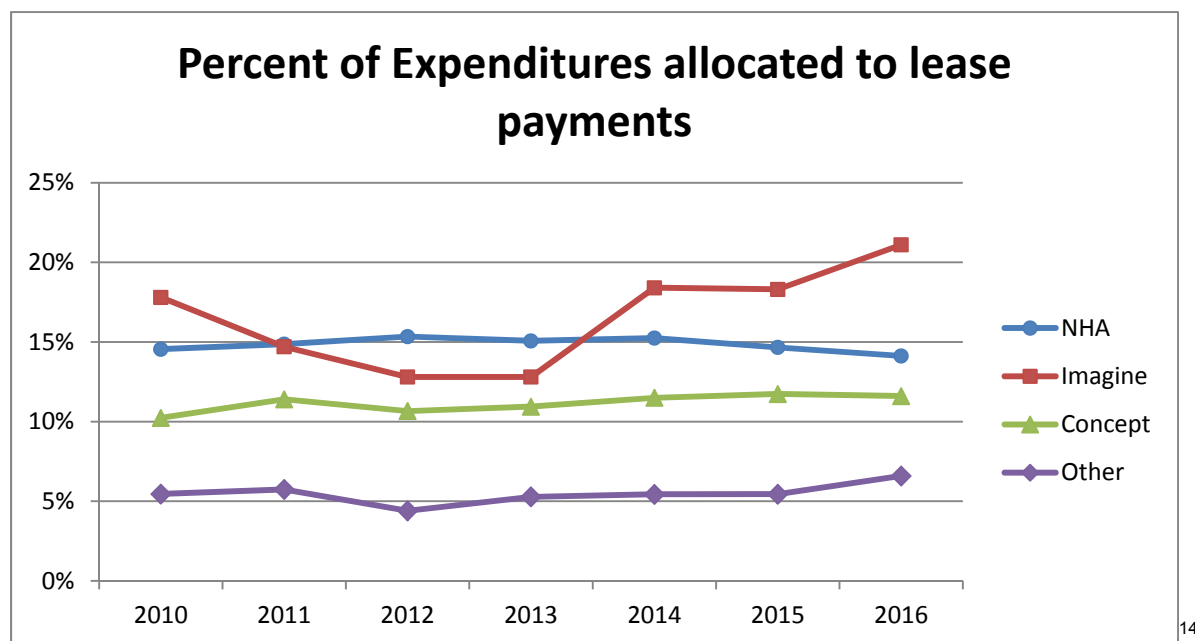
There is only one instance in which this has occurred in Ohio. The Cleveland Metropolitan School District passed a property tax levy in which part of the proceeds were earmarked for community schools. One-fifteenth of revenues from this levy are distributed among 18 Cleveland community schools based on the number of students who live in the Cleveland Metropolitan School District who attend that school. This levy was part of the Cleveland Plan, an initiative to reinvent public education in the city and to serve as a model of innovation for Ohio.

Leasing Facilities

Due to difficulties obtaining loans or secure funding for building purchases, community schools frequently lease facilities, as was the case for more than 90% of the community schools included in this analysis. In an article published July 18, 2013, on MarketWatch titled “Bond Market gets an ‘F’ for Charter School Funding,” Michael Rubinger, the former president of the Local Initiatives Support Corporation, a US non-profit that works to support community development, discusses financing as being one of the largest hurdles for charter school growth. He writes, *“More dollars could go toward teachers, guidance counselors and books, if only the municipal bond market was prepared to be a ready source of affordable capital. Sadly, underwriters and investors aren’t sure how to assess charter risk profiles. So, they charge a premium for the rare school that does try to tap the bond market — much more than public school districts pay to borrow. That leaves charters with less to spend in the classroom and keeps some schools from opening altogether.”*

The same article also notes that in New York State, community schools not housed in district space typically spend 15 percent of their budget on rent or mortgages, and these amounts are even higher in New York City¹³.

Since the real estate market in Ohio differs from that of New York, an analysis was performed to compare the percentage of lease expenditures allocated to rent. This revealed that Ohio is not immune to this issue. Two of the three management companies we examined paid percentages similar to those in New York. From 2010 to 2016, Imagine Schools had the highest median average at approximately 17.8 percent of expenditures for base rent payments, followed by National Heritage Schools with 14.9 percent. Concept Schools' median average was 11.4 percent, and our other sample community schools in Ohio median averaged 5.4 percent.



As evidenced by the table, schools of the three management companies have at minimum been allocating more than twice as much of their expendable resources towards facilities than the sample of “Other” community schools reviewed (sample other consisted of six randomly selected Ohio community schools). This is public money spent on rent rather than student education. These figures are conservative and exclude additional building-related expenditures the schools may have incurred such as building maintenance, property taxes, insurance, and leasehold improvements which, depending on individual lease provisions, also may have been the school’s responsibility.

¹³ <https://www.marketwatch.com/story/bond-market-gets-an-f-for-charter-school-funding-2013-07-18>
¹⁴ Unusual fluctuations between years for Imagine managed schools are a result of several factors; but do not affect the end result. In fiscal year 2011 Imagine Schools, Inc. opened two new schools. From 2011 through 2013 Imagine Schools, Inc. made rental payments to Schoolhouse Finance, LLC on behalf of these two schools, resulting in the sharp decrease in average percentage of Imagine managed community schools in 2011 and an increase in 2014. Percentage of expenditures allocated to lease payments experienced a sharp increase again in 2016 as a result of a combination of factors including the closure of two schools that had been operating under lower lease rates and a decrease in revenues due to decreased enrollment¹⁴ (and as a result of a decrease in expenditures) experienced by four Imagine managed community schools in fiscal year 2016 per school audited financial statements and school closeout agreed upon procedures obtained from ohioauditor.gov.

From an initial view of these trends and comparisons it may indicate overspending, however it is difficult to determine whether the lessor is in fact making a profit due to complexities such as the method of financing used by the property owner, location, and party responsible for expenses associated with the property including insurance, maintenance, renovations, and property taxes.

Community School Facility Lessor

Community schools that rent their facilities held leases from a variety of different lessors including, churches, private companies, local school districts, and management companies. A commonality found for those community schools operating under the three management companies reviewed here -- Concept Schools, Inc. (Concept), Imagine Schools, Inc. (Imagine), and National Heritage Academies (NHA) -- was that each management company had a favored real estate firm which held a stake in all or the majority of facility leases entered into by the schools operating under that management company. Community schools operating under these three management companies consistently leased properties that had either leasing or ownership ties related to their management's preferred real estate firm, as opposed to unrelated third parties. By focusing on a niche market, these real estate firms often were able to provide community schools with turn-key leases as the buildings were already fitted or had been repurposed as classrooms, a benefit many generalized third party lessors often cannot provide.

National Heritage Academies and Imagine Schools Inc. each have their own real estate division, operating as a wholly owned subsidiary or branch of the management company.

Charter Development Company (CDC) is a for-profit wholly owned subsidiary of NHA which performs real estate property finance, purchase and renovation services for NHA managed schools. All NHA school facility lease agreements were held directly with NHA, with CDC acting as "master landlord." All properties leased by NHA schools were owned by CDC.

Imagine Schools, Inc. consists of three branches -- Imagine Schools for-profit, Imagine Schools not-for-profit, and Schoolhouse Finance LLC (SHF). SHF is a for-profit subsidiary of Imagine Schools, Inc provides real estate financing services. All twelve of the Imagine managed community schools included in this review held leases that were run through SHF: Properties owned by SHF were leased directly to schools; properties not owned by SHF were leased to SHF by the property owner and subleased to the school. SHF has owned the property rented by those community schools for ten of the twelve Imagine community schools reviewed, of which eight have since been sold to third parties after entering into a sale and leaseback agreement. Leased properties without former ownership ties to SHF are currently owned by the Catholic Church and a private commercial real estate development company that each act as "Prime Landlord" on the sublease agreements held between SHF and the schools for those properties.

The majority of schools operating under the third management company, Concept Schools Inc., held leases with subsidiaries of New Plan Learning, LLC. New Plan Learning, LLC (NPL) is a separate unrelated not for profit real estate management firm dealing exclusively with Concept-managed community schools. NPL is designated as a 501(c)(3) tax-exempt organization because it provides facilities and facilities management to the charter schools it manages. Property acquisition is performed by NPL through a series of single member LLC's that act as pass through entities acting on behalf of the parent company; these individual single member LLC's only function to collect and distribute lease proceeds to NPL. All revenues and activity of the single member LLC's are reported by NPL on its consolidated financial statements, and therefore are considered disregarded entities. NPL also has a subsidiary, known as Breeze, Inc. that is a 501(c)(2) title-holding corporation, which holds several properties and reports its own Form 990 to the IRS.

Methods of Financing used by Management Companies and Other Private Related Companies

The methods of financing those management-company-related real estate firms used in procuring properties included large open-ended mortgage notes, sale and leaseback agreements with real estate investment trusts (REITs), issuance of individual mortgage notes, and issuance of public bond notes. Each of these methods has varying complexities which could affect lease rates.

Third Party Open-Ended Mortgage Note

Large open-ended mortgage notes to finance properties were used by all three management company real estate firms. This gives the mortgagee access to funds which can be used continuously for the purchase of any number of properties as well as any renovation or other related costs under a single debt issuance. Open ended mortgages give the mortgagee more freedom in purchasing, renovating, or repurposing properties, and can eliminate the need for supplemental debt issuances should the costs exceed estimates.

Although this method is likely the simplest from a purchaser standpoint, it is difficult to tie individual properties to their allocated portion of debt as a single open-ended mortgage can be used to finance multiple properties across any number of states.

These notes often contain debt covenants requiring the borrower to maintain a certain level of capital or maintain a reserve balance account. In fact, multiple instances were noted with New Plan Learning having to temporarily borrow capital from Concept managed schools to maintain compliance with debt covenants.

Third Party Bond Issuance

Bonded debt can be a significant factor in determining lease rate. Required annual payments typically increase over the life of a bond; as a result the lessor must charge a rate concurrent with these annual payments to avoid an operating loss, noncompliance with debt covenants, or default on payments.

Of the three management companies reviewed, New Plan Learning was the only school that issued bonds to finance purchases. In 2011 New Plan Learning (Concept) issued \$33,120,000 public educational facility revenue bonds to finance the purchase and renovation of four Concept managed schools: three in Ohio and one in Illinois. The bonds are 30-year variable-term bonds with interest rates ranging from 7 percent to 9.5 percent and were Fitch rated BBB-. The bonds are collateralized by the four school's lease obligations.

The chart below shows that the annual lease payments required from each school, the sum of those payments, the bond payments due and the gain that NPL makes as a result.

Fiscal Year Ending:	HSA Dayton HS	HSA Springfield	HSA Toledo	Chicago MSA	Total School Lease Payments paid to NPL	NPL Bond Payments Due	
2012*	310,781**	175,200	276,000	1,092,319	1,854,300	2,132,913	
2013*	531,324	494,964	503,477	1,165,000	2,694,765	2,620,644	
2014*	711,279	591,141	662,461	1,165,000	3,129,881	2,620,644	
2015*	777,324	644,376	716,278	1,245,000	3,382,978	2,835,644	
2016*	777,800	650,516	734,136	1,255,000	3,417,452	2,835,219	
2017*	784,227	650,534	734,656	1,257,572	3,426,989	2,832,894	
2018	791,516	664,313	741,967	1,267,756	3,465,552	2,832,669	
2019	798,792	658,519	755,100	1,277,932	3,490,343	2,833,419	
2020-2041	20,060,926	16,697,859	18,657,358	29,756,160	85,172,303	69,043,907	
Total	25,543,968	21,227,422	23,781,433	39,481,739	110,034,562	90,587,951	
*Denotes actual rent payment per school Notes to the Financial Statements						NPL Cost of Issuance:	1,186,690
** School received a \$116,291 donation from New Plan Learning, amount shown net of donations received						Reserve Balance Requirements:	4,173,569
						Total Cost of Bond Issuance	95,948,210
						Total Payments Received from Bonded Schools:	110,034,562
						New Plan Learning Gain on Bond Issuance:	14,086,352

The intended use of bond revenues is to finance the acquisition of Chicago Math & Science Academy property and construct a gymnasium (\$12,810,000), refinance and renovate Horizon Science Academy Springfield (\$6,110,000), refinance and build a gymnasium for Horizon Science Academy Dayton High School (\$7,350,000) and finance the acquisition and renovation of Horizon Science Academy Toledo (\$6,850,000)¹⁵. In order to receive these benefits each of the schools entered into a 30-year absolute net lease agreement in which lessee is responsible for all costs associated with the property including structural maintenance and reimbursement to New Plan Learning of its allocable portion of any fees, charges, or expenses incurred in association with the bond issuance or leased property. Although the bond issuance is secured by lease payments, New Plan Learning will maintain full ownership and control of these properties at the end of the lease term.

Sale and Leaseback Agreement

Sale and Leaseback agreements are often used as a method to obtain immediate cash. The owner sells the property, which is in turn leased back to the seller by the new owner. This method of financing was used by one Concept school and several Imagine schools that were included in the examination. However, the implementation of this method of financing was different between these two management companies: the Concept school was directly involved in the transaction, while the Imagine schools were indirectly involved.

¹⁵ Per New Plan Learning Series 2011 Bond Issuance Official Statement

The Concept school involved in a sale-leaseback agreement was the selling party of the transaction and Breeze, Inc., a subsidiary of NPL, was the purchaser. In 2000 the school entered into a 20-year land installment agreement for the purchase of this property for \$2.8 million, at an interest rate of 10%. In 2005, the selling party exercised a debt call option that required the school to make a balloon payment of the remaining balance of the land installment agreement, which would give them the deed to the property. The school was unable to obtain financing for this balloon payment. As a result, the school sold the rights to the land installment agreement to Breeze, Inc. Breeze, Inc. paid a total of \$2.7 million, of which approximately \$2.5 million was paid to the former land owner for the remaining balance due on the land installment contract, and the remaining \$200,000 was to be paid the school. Breeze, Inc then leased the property back to the school (see section Spotlighted Schools). Imagines' wholly owned subsidiary Schoolhouse Finance, LLC (SHF) entered into sale-leaseback agreements with REITs. Properties previously owned and renovated by SHF were sold to REITs. These properties were leased from the REIT to SHF, the property was in turn leased to the school with SHF acting as landlord and the REIT acting as master landlord, thus providing a corporate guarantee for the lease. This transaction took place for properties of eight different Imagine schools in Ohio.

Each of the school leases associated with the REIT were 25-year, absolute net agreements with the tenant responsible for all maintenance, including structural and roof maintenance and annual rate increases¹⁶. Since both SHF and the REIT are private companies, the master lease agreements between the two and amounts each had invested in the properties were not available therefore auditors were unable to concretely determine the amounts those schools were surcharged by SHF in the sublease agreements..

In 2017 and 2018 however, investment brochures were posted for 7 of the Ohio Imagine school properties under REIT ownership at which point the listed schools were all at least 7-10 years into their 25 year lease agreement. . The investment buy in price was marked up a median of 55% above the original purchase price¹⁷, however offered investors fee simple ownership, no landlord responsibilities, and an 8.5 percent investment cap rate¹⁸. SHF may have been profiting off of these lease agreements is that annual rent provided in the investment brochure did not agree with the school annual base rent for any of the seven schools as detailed in the school lease agreements; school rent was higher. Utilizing the same calculation, substituting school annual base rent paid in that fiscal year¹⁹ averaged a 10 percent investment cap rate. Whether the risk absorbed by SHF for acting as lease intermediary and guarantor gives adequate basis for the excess rent being paid by the schools is a subjective judgment, however in a lawsuit brought against Imagine Schools. Inc. by a Missouri based school whose leased property had also been part of a sale-leaseback transaction between SHF and a REIT alleging excessive lease payments, the federal district court judge ruled in favor of the school and ordered Imagine Schools, Inc. to reimburse the difference between the amounts paid by the school and estimated lease market value. See Section Market Analysis of Leased Properties in Ohio for additional information on the lawsuit.

In addition to the presumed surcharge on school lease rate, SHF has also been able to hedge some of the financial risk involved in being lease intermediary by use of contract provisions that require the leased school to be managed by Imagine Schools, Inc. Three instances of the relationship between SHF and Imagine Schools, Inc. being used to mitigate risk of school sublease default were noted during the AOS analysis.

¹⁶ Per School Leases

¹⁷ Per County Auditor property records

¹⁸ Per Marcus & Millichap offering memorandums

¹⁹ Per School lease agreements

Two similar instances occurred at the end of fiscal year 2013, when two Imagine managed community schools leasing properties purchased via sale-leaseback agreements between SHF and the REIT were closed. One in Akron, Ohio, was ordered to close by the Ohio Dept. Of Education (ODE) as a result of continued poor academic performance; the other, in Columbus, Ohio, ceased operations as a result of governing board decision (reason unstated). The following school year, Imagine Schools, Inc. opened two new schools under different school names and sponsorship, operating in the same locations and utilizing the same lease agreements that had been held by the school's predecessor. Under current Ohio law, schools boards, not management companies, are held responsible for community school closures. As a result, management companies with sufficient resources can essentially reopen schools that have been closed under a new name and IRN with little risk involved.

A third instance in which SHF was able to hedge risk within its corporate lease guarantee with the REIT property owner was as a result of a contract provision contained in each SHF lease deeming severance of ties between the school and Imagine Schools, Inc., for any reason, a breach of contract. In fiscal year 2015, the governing board of a formerly (then currently) Imagine managed community school operating in Cleveland, Ohio, decided to contract with a different management company for the following school year rather than renew its management agreement with Imagine, Schools Inc. As a result, the school negotiated a new lease agreement directly with the REIT owner, releasing SHF from all obligations contained in the original master lease agreement between SHF and the REIT. The contract provisions of the lease agreement were not materially altered, however, school's annual base rent decreased \$402,500 from the prior year when SHF had been acting as intermediary.

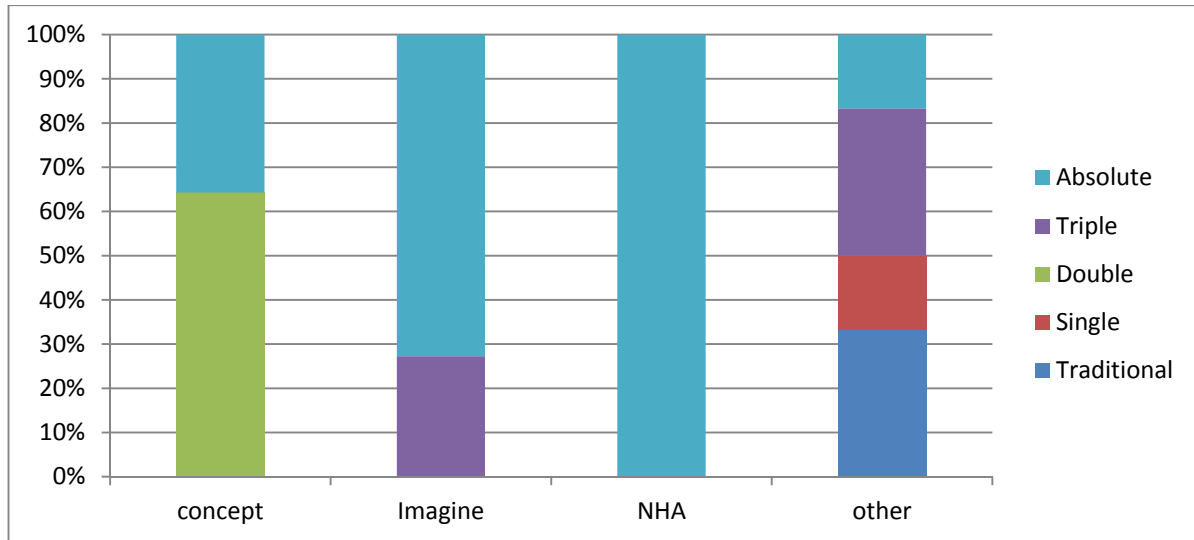
Lease Provisions

Lease agreements may contain a variety of provisions which determine the party responsible for certain costs associated with the property above and beyond base rent. In a traditional lease, the landlord retains the responsibility for paying property taxes, insurance premiums and maintenance costs; these costs covered by the landlord as they are built into the standard base rent paid by the tenant leases. Other lease types include single net, double net, triple net, and absolute net.

Each "net" represents an additional cost category the tenant absorbs responsibility for payment. Single net leases are the least common of the four in which the tenant is typically responsible for paying the property taxes associated with the rented property; double net leases require the tenant to pay two cost items, typically property taxes and insurance associated with the property; triple net leases require the tenant to pay three cost items, typically property taxes, insurance, and non-structural maintenance associated with the property; and absolute net leases require the tenant to pay all costs associated with the property including property taxes, insurance, both structural and nonstructural maintenance of the property which includes maintaining the roof and structure of the building, and any other costs associated with the property that the landlord may incur.

When costs associated with the rental property are absorbed by the tenant, the need to build those costs into the base rent fee is removed. This is reflected by lower lease rates, reduced from what they otherwise would be had the parties entered into a traditional lease agreement.

Auditors reviewed 39 separate lease agreements entered into by 37 schools included in our examination (certain schools operated in multiple buildings under separate lease agreements) which included 13 Concept schools, 10 Imagine, 8 NHA, and 6 Other. The below figure shows the percentage ratio of lease types encountered for each group.



The majority of Concept managed school leases with New Plan Learning related entities were double net leases where the tenant was responsible for property tax and insurance expenses, and contained clauses that the tenant would be responsible for leasehold improvements. Two of the four absolute net leases entered into by concept managed schools were with entities not related to NPL.

The majority of Imagine managed school leases in the first decade of the 2000's were triple net leases, however as Imagine Schools real estate branch, Schoolhouse Finance, LLC began dealings with Real Estate Investment Trusts, and entering into sale and lease back agreements, typical lease agreements for those schools have become absolute net lease agreements, on freshly renovated properties.

National Heritage Academy school leases were all discernable as absolute net leases, however were annually renewable. Since many schools often have difficulties paying for large expenses such as structural maintenance and renovations, these payments were in fact paid for by National Heritage Academies, with the caveat that the lease rate would immediately increase the following year upon renewal of the lease agreement. The Auditor of State could not however find evidence included in National Heritage Academy school work papers, board minutes, or lease agreements to substantiate the additional costs incurred by National Heritage Academies and the corresponding increase in lease rate.

Board Oversight of Facility Procurement and Lease agreements

National Heritage Academies

Each School operating under National Heritage Academies (NHA) that we reviewed had delegated the responsibility of procuring a school facility to NHA through a clause contained in the management agreement stating:

“NHA shall lease or otherwise cause a facility to be made available to the Board for school classroom facilities.”²⁰

²⁰ This excerpt was taken directly from Orion Academy/NHA Management Agreement. This clause was included in the management agreement for all NHA schools reviewed.

The lease agreements held by NHA schools follow a uniform shell for each facility leased. All NHA school leases reviewed were one year annually-renewed, and discernable as triple net leases (tenant responsible for property taxes, insurance, and building maintenance)²¹. The consistency of terms above market value lease rates offer evidence that minimal negotiations were performed by the school's boards in the lease approval process. In review of NHA board members, schools operating in the same area tended to have the same Board of Trustees. All five board members being the same for both of the Cincinnati area NHA schools, a different five serving for both Cleveland area schools, and a different five serving for both Dayton area schools. This is an allowable practice in accordance with the ORC.

Imagine Schools Inc:

Provisions contained in the management agreement each school entered into when utilizing the services of Imagine emphasized the importance of Imagines' approval and role in the selection of the school's facility.

The following is included in Article I Contracting Relationship of Imagines' management agreement with each school:

"The Board hereby contracts with Imagine, to the extent permitted by law, to provide all charter school management services on the terms and conditions set forth in this Agreement, including without limitation the administration and supervision of the personnel, materials, equipment, and facilities"²²

The management agreement continues to state in Article III Obligations of Imagine:

"Imagine will assist the Board in locating a facility suitable for the operation of the Charter School (the "Charter School Facility"). The Charter School Facility shall be subject to Board approval, which approval shall not be unreasonably withheld ... The Board and Imagine shall consult with one another prior to making or accepting any material modification to the Charter School Facility, or any amendment or modification to the terms and conditions of any lease between the Board and a third party landlord or any purchase and sale agreement between the Board and a third-party Seller in connection with the Charter School Facility. The Board shall exercise good faith in acting upon the reasonable recommendations of Imagine related to the Charter School Facility. Imagine will review any lease for the Charter School Facility."²³

Although the management agreement does not explicitly delegate Board authority to Imagine, subjective language used throughout the management agreement such as "The Board shall exercise **good faith** in acting upon the **reasonable recommendations** of Imagine related to the Charter School Facility" and "[Board] approval shall not be **unreasonably** withheld" allude to an assumed trust between the school Board and Imagine, which in practice can hinder the effectiveness and integrity of board oversight. This was corroborated in a report published by [policymattersohio.org](http://www.policymattersohio.org), a non-profit Ohio policy research group, in which a former Imagine School Board member discussed his reasons for resigning from the school Board of Trustees, including the comment, "We finally concluded that what was desired from the administration was for the board to be a rubber stamp rather than a governing body"²⁴

²¹ Per analysis performed by DAS

²² Imagine Management Agreement Article I Section B

²³ Imagine Management Agreement Article III Section D

²⁴ <http://www.policymattersohio.org/wp-content/uploads/2011/09/ImagineSchools2010.pdf>

Concept Schools, Inc.

Thirteen of the eighteen Concept managed community schools in Ohio currently have or previously have held leases with a subsidiary of New Plan Learning. Although maintaining sovereignty from and denying relations with Concept Schools, Inc., regular overlapping of Board members between New Plan Learning and Concept Managed schools has been documented, in addition to New Plan Learning personnel relations with Concept Schools, Inc.

Former and current relationships between Concept Schools, Inc, and New Plan Learning with two of the original persons who founded Horizon Science Academies, and subsequently Concept Schools, Inc. One of whom also co-founded New Plan Learning, and has since served on the Board of Directors for Breeze, Inc. and Concept Management Company²⁵, the other of whom who also co-founded Concept formerly served on the Board of Breeze, Inc.

Currently, New Plan Learning operates a four-member board; of the four members serving in 2017, two member also served on the school boards for seven of the seventeen Concept managed schools in Ohio.

The Board President of New Plan Learning²⁶, also was listed as one of the initial directors of Concept Schools – Ohio, Inc. Articles of Incorporation²⁷, and, as of 2019, served as president on the governing board for Horizon Science Academy of Cincinnati, Horizon Science Academy of Dayton Elementary School, Horizon Science Academy Dayton High School, and Horizon Science Academy Dayton Downtown²⁸. This individual also formerly served on the board for Horizon Science Academy Columbus High School and Horizon Science Academy Toledo²⁹.

The other individual who also served on the Board for New Plan Learning³⁰, in conjunction with being a Board member for Horizon Science Academy Cleveland High School, Horizon Science Academy Cleveland Middle School, and Horizon Science Academy Denison Middle School³¹.

Other members of the New Plan Learning staff including the treasurer, and, secretary³² have also served on the school boards of Concept managed community schools. Though neither currently serve, collectively they have served on the board of Horizon Science Academy of Columbus Elementary School, Horizon Science Academy of Columbus Middle School, Horizon Science Academy of Columbus High School, Noble Academy Columbus, Horizon Science Academy Toledo and Horizon Science Academy Cincinnati³³.

In all, these members of New Plan Learning have served on the board for twelve of the seventeen Concept managed community schools in Ohio; nine of which have held leases with a New Plan Learning subsidiary, which constitutes a conflict of interest

²⁵ Per New Plan Learning Series 2011A Official Bond Statement

²⁶ Per New Plan Learning 2016 Form 990 obtained from Guidestar

²⁷ Per Concept Schools – Ohio, Inc. Articles of Incorporation located at <http://www2.sos.state.oh.us/reports/rwservlet?imgc12g&Din=200613000110>

²⁸ Per School website, last checked 12/19/17

²⁹ Per AOS complaint letter Horizon Science Academies 2016-CA00643

³⁰ Per New Plan Learning 2016 Form 990 obtained from Guidestar

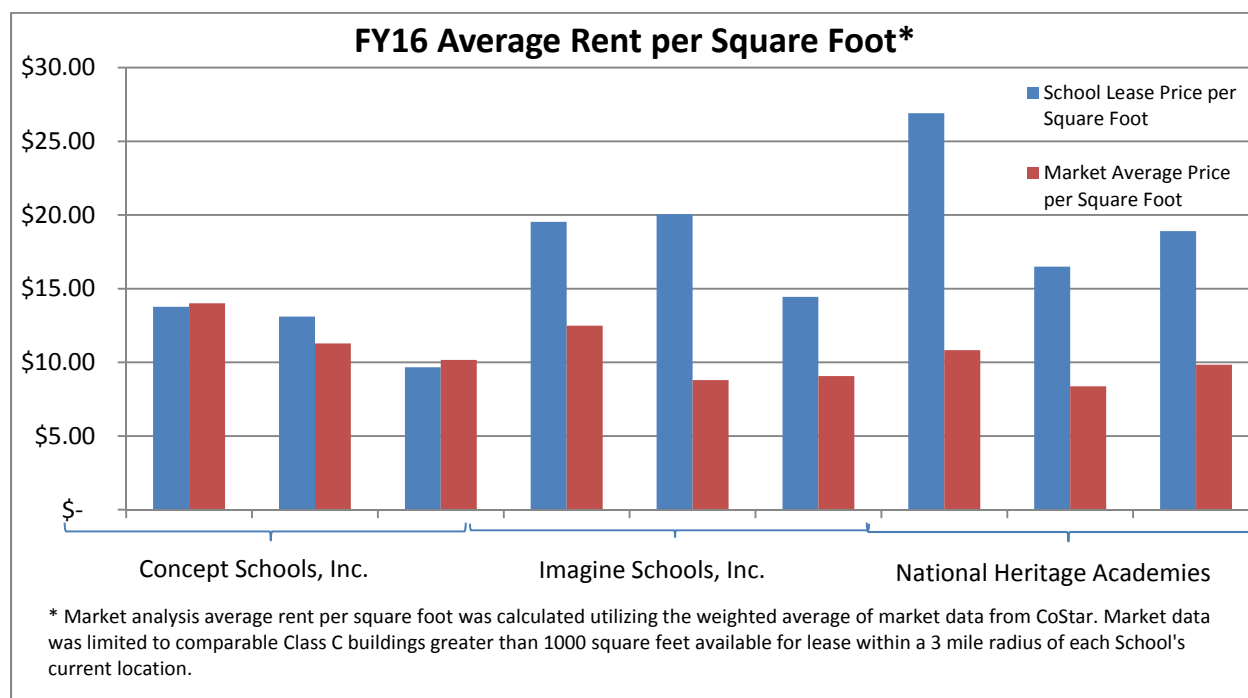
³¹ Per School website, last checked 12/19/17

³² Per New Plan Learning 2016 Form 990 obtained from Guidestar

³³ Per AOS complaint letter Horizon Science Academies 2016-CA00643

Market Analysis of Leased Properties in Ohio

Factors that aid in determining market lease rates can include location, market demand, availability, and inflation; however certain factors can affect individual lease rates that would give basis for varying from the going market rate. Contract provisions, method used to finance the purchase of the property, lease term, condition, property size, and credit worthiness of the lessee are all factors that could affect lease rates. Community schools can be viewed as risky tenants due to the high number of community schools that close each year. In fiscal year 2017 there were 361 community schools operating in Ohio³⁴. During that year, 25 closed (approximately 7 percent).³⁵ Reasons for a school closing vary but include financial difficulties, low academic performance, low enrollment, poorly rated sponsors and non-renewal of contract.



The Ohio Auditor of State requested the aid of the Ohio Department of Administrative Services (DAS) in performing a market analysis to determine the average cost per square foot for buildings in the school's direct surrounding area.³⁶

³⁴ <http://education.ohio.gov/Topics/Community-Schools/Directory-of-Community-Schools-Sponsors-and-Operat>

³⁵ <http://education.ohio.gov/getattachment/Topics/Quality-School-Choice/Community-School-DRAFT/Sections/Public-Documents-and-Reports/List-of-closed-schools-and-the-reason-for-closure.xlsx.aspx>

³⁶ Note: the Ohio Department of Administrative Services (DAS) is an independent state agency. DAS's Real Estate division is responsible for analyzing and procuring lease agreements for various state agencies in Ohio. DAS's resources and expertise in this area allowed them to generate reports, enabling the AOS to analyze comparative market lease agreements. DAS had no influence in the data used for the AOS's analysis, nor gave any opinion on the matter. Information provided to the Ohio Auditor of State strictly for informational purposes. The information contained above and in this report in no way reflects the thoughts or views of DAS.

The search area was limited to comparable Class C buildings greater than 1,000 square feet available for lease within a three-mile radius of the selected school.³⁷ For the analysis, three schools were haphazardly selected for each management company under review. Trends in the table above show that the majority of these community schools under management companies are being charged rental rates significantly above market value. Two of the nine community schools (both under the management of Concept Schools, Inc.) were priced slightly below going market value, jointly the two schools paid a total of \$32,350 under the assessed market value. Seven of the nine community schools analyzed however had rent significantly higher than the going market value. Total annual amounts paid above market value for each individual school ranged from \$65,560 to \$867,170 with a median of \$371,495³⁸.

All of the schools analyzed in the above table were under lease agreement with the real estate branch associated with each school's management company with the exception of Concept Schools, Inc. sample item No.1, which was housed in a former parochial school building leased from the catholic diocese. The NHA School which paid the highest rent per square foot was a result of significant renovations, construction and investment performed by CDC. From fiscal year 2006 to fiscal year 2007, the rate increased by 66 percent rent due to extensive building renovations, which were completed in July 2008, being the cause for increases in fiscal year 2007 and fiscal year 2008. In fiscal year 2009, CDC purchased an adjacent lot to be used by the school for parking, and in April 2010 (late fiscal year 2010) the parking lot was resurfaced, giving basis to rental increases in fiscal year 2009 and fiscal year 2011. Renovations/construction/lot purchase cost estimates were obtained from Hamilton County Auditor.

Much like the federal government, the State of Ohio has its own bidding requirements and procedures to obtain the best rates possible when leasing property. The Real Estate division at DAS provides its services in finding facilities to many different state agencies in Ohio. The procedures followed by DAS closely match the procedures undertaken by the federal government. In Ohio, DAS performs a market analysis by pulling historical and current real estate data for the desired area and surrounding buildings. Following a value analysis, facilities that match the desired criteria are brought to the agency to assess the options and decide which property best suits needs. Finally, DAS will directly negotiate lease terms with the property owners. For the schools examined, there was no conclusive evidence available to show any similar measures had been taken by the schools themselves or the governing boards. Although traditional school districts are required by Ohio law to follow bidding procedures in certain instances for large contracts, community schools are not.

Ohio is not the only state that does not require community schools to follow bidding procedures for large contracts, nor is this condition exclusive to Ohio. Renaissance Academy for Math & Science, an Imagine managed community school in Missouri whose property was also part of a sale and leaseback agreement entered into between SHF and a REIT, filed a lawsuit against Imagine Schools, Inc. Among various complaints, the lawsuit alleged Imagine Schools, Inc. had failed to disclose its relationship with Schoolhouse Finance, LLC and used its position of trust and confidence to negotiate, with its own sister company, leases which significantly exceeded market value, The federal district court ruled Imagine Schools, Inc. had committed a breach of fiduciary duty and as part of the ruling was ordered to repay the school \$935,400, the estimated amount that the school had been charged above reasonable market value during the 46 months the school leased facilities from Imagine Schools, Inc.

³⁷ Market analysis data reflects current market availability data per CoStar accessed December 13, 2017 by DAS provided to the Ohio Auditor of State

³⁸ Building square footage information obtained from County Auditor website and school leases, Rent expenditures per school audited notes to the financial statements

Spotlighted Schools

Concept Schools, Inc. - Horizon Science Academy of Cleveland

Horizon Science Academy opened in 1999 and currently leases its facility from Breeze, Inc, a subsidiary of New Plan Learning, a real estate company dealing exclusively with Concept managed schools, however maintains sovereignty in its relationship with Concept Schools, Inc. The property the school is located on is owned by Breeze, Inc. and was purchased in 2005 for \$2.7 million³⁹.

The property the School is located on was originally owned by OMH Holdings, LLC. In 2000 the Academy entered into a 20 year land installment agreement with OMH Holdings, LLC for the purchase of this land and the buildings located for \$2.8 million, at an interest rate of 10%. In 2005 OMH Holdings exercised an optional call provision contained in the contract, requiring the School to make a balloon payment of the remaining balance due towards the contract.

The school was unable to obtain financing for this balloon payment, and, as a result Breeze, Inc.(a NPL subsidiary) purchased the rights to the Land installment agreement from the school for 2.7 million (2.5 million paid to OMH holdings for the remaining balance on the Land Installment contract, and 200,000 to the Academy) and the deed was transferred to Breeze, Inc. Prior to this transfer the Academy had spent approximately \$1.6 million on building improvements between 2000 and 2002, which were transferred to Breeze, Inc. at the time of the sale.

In 2005 the Academy purchased and installed modular buildings on the premises at a cost of \$822,000, to be paid over a 10 year period at an interest rate of 8.925%. These buildings were leased to Horizon Science Academy Middle School. In 2008 the modular buildings were sold to Breeze, Inc. for \$800,000 (\$317,000 was to be paid to the Academy and \$483,000 allocated to the remaining balance on the modular buildings.)

The Academy did not however receive cash payment for either sale transaction. Amounts owed to the school from Breeze, Inc. were instead paid for via monthly rent credit of approximately \$8,700 per month and are scheduled to be paid off at the end of June 2018, interest free.

In 2008 Breeze, Inc. constructed a gymnasium for the Academy. The cost of construction was \$1.33 million, financed via a 10 year note. The Academy's monthly rent was temporarily increased in consideration of the construction for a period of 10 years, amounts tied directly to the payment schedule of the debt note obtained by Breeze, Inc.

The lease agreement currently held with Breeze, Inc. is a double net lease (Tenant responsible for real estate taxes and insurance premiums). Annual base rent when the lease was entered into in 2009 was \$228,000, and has had an annual increase of 4%, in addition to temporary \$203,000 annual surcharge for reimbursement of the gym construction costs, and temporary \$104,400 annual rent credit for property purchased by Breeze, Inc. from the school.

A market analysis performed over comparable buildings available for lease within a three mile radius of the area directly surrounding the building determined the market average lease rate was \$10.17 per square foot. The school lease price per square foot paid in fiscal year 2016 equated to \$9.67per square foot. The resulting lease payment under market average for fiscal year 2016 was approximately \$26,000.⁴⁰

³⁹ Per Breeze Inc. Land Installment Purchase Agreement

⁴⁰ Per DAS Rent per Square Foot Spreadsheet

From July 1, 2004 through June 30, 2016 the lease payments have accounted for approximately 9.2% of all expenditures and 9.3% of all revenues received during this period.⁴¹

Imagine Schools, Inc. - Harvard Avenue Performance Academy

Harvard Avenue Performance Academy opened in 2006 and subleased its facilities from Schoolhouse Finance LLC, a branch of Imagine Schools, Inc. from September 2006 through June 2016. The building occupied by the Academy was initially purchased by Schoolhouse Finance LLC in 2006 for \$700,000. The property was later sold to Jerit CS Fund I LLC (a subsidiary of EPR Properties, a real estate investment trust) in July 2007 for \$6.1 million and leased back to Schoolhouse Finance LLC. The property 2017 market value was \$2.68 million⁴².

The sublease agreement was an absolute net sublease (subtenant responsible for all costs associated with the building including property taxes, property insurance, maintenance, structural maintenance, and reimbursement of any costs incurred by the sub-landlord in association with the management of the property) with base rent for the property is \$737,388 with an annual increase of the lesser of the CPI or the maximum amount allowed by law.

Building improvement costs incurred by Schoolhouse Finance, LLC prior to the sale of the property in 2007 amounted to approximately \$5.5 million⁴³, resulting in a total initial investment of \$6.2 million. The building was sold for \$6,117,606 in July 2007, prior to the sale-leaseback of the property SHF received \$722,961 in lease payments from the Academy.

The sublease agreement with SHF included a provision stating “Lessee may terminate this Agreement prior to the end of the term specified ... in the event of (i) the termination of the (Imagine) Operating Agreement”⁴⁴. At the end of Fiscal year 2015 the Academy terminated its management agreement with Imagine Schools, Inc. resulting in the termination of the sublease agreement with SHF⁴⁵. The Academy entered into a lease agreement directly with the building owner, Jerit CS Fund I LLC for the same property⁴⁶. Upon doing this, annual rent dropped from \$918,896 in fiscal year 2015⁴⁷ to \$682,232 in fiscal year 2016⁴⁸.

A market analysis performed over comparable buildings available for lease within a three mile radius of the area directly surrounding the building determined the market average lease rate was \$8.80 per square foot. The school lease price per square foot paid in fiscal year 2015 while leasing from SHF equated to \$20.06 per square foot and \$14.90 per square foot in fiscal year 2016, while leasing from Educational Capital Solutions. The resulting lease payment over market average was approximately \$515,865 in fiscal year 2015 and \$279,200 in fiscal year 2016.⁴⁹

⁴¹ Per Lease Agreement Spreadsheet

⁴² Per Cuyahoga county Auditor

⁴³ Per Harvard Avenue Performance Academy First Lease Amendment

⁴⁴ Per Harvard Avenue Performance Academy Second Lease Amendment

⁴⁵ Per Harvard Avenue Performance Academy Transition Agreement with Imagine Schools, Inc.

⁴⁶ Per Harvard Avenue Performance Academy Management Agreement with performance Academies, Inc

⁴⁷ Per Harvard Avenue Performance Academy Audited 2015 Notes to the Financial Statements

⁴⁸ Per Harvard Avenue Performance Academy Audited 2016 Notes to the Financial Statements

⁴⁹ Per DAS Rent per Square Foot Spreadsheet

From July 1, 2006 through June 30, 2015 the lease payments accounted for approximately 17.2% of all expenditures and 17.3% of all revenues received during this period. From July 1, 2015 to June 30, 2016 lease payments accounted for 12.4% and 12.6% of expenditures and revenues, respectively.⁵⁰ The terms of the original Master Lease Agreement between SHF and Jerit CS Fund I LLC is unknown therefore a determination of SHF's estimated net profit/loss is not determinable for the time period from July 2007 through June 2015.

National Heritage Academies - Orion Academy

Orion Academy opened in 2004 and leases its facilities from its management company, National Heritage Academies (NHA). The facility occupied by Orion Academy is owned by Charter Development Company LLC (CDC), a wholly owned subsidiary of NHA operating as Master Landlord in the Lease agreement. The property was purchased by CDC in 2004 for \$350,000 and held a 2017 market value of \$3,094,960⁵¹.

The lease between NHA and the Academy is either a triple net or absolute net lease⁵² (tenant is responsible for all costs associated with the property, however the party responsible for structural maintenance of the building is not stated). Annual base rent was initially \$736,000 in the school's first years of operations in 2004 and 2005, however has since gradually increased via lease amendments to \$1,451,040, the annual rate as of 2016.⁵³

The Management Agreement between Orion Academy and NHA states "NHA shall lease of otherwise cause a facility to be made available to the Board for school classroom facilities"⁵⁴, additionally the lease includes a provision stating "In the event Landlord makes capital improvements to the premises, or acquires additional property for the benefit or use of Tenant, then the rent paid by tenant shall be promptly adjusted accordingly to compensate Landlord for its additional economic investment."⁵⁵ Though legal, the result of this is reduced Board control in the determination of facility and reduced control over lease rates to be paid by the Academy. These contract provisions were included in all management and lease agreements reviewed for NHA managed schools in Ohio.

A market analysis performed over comparable buildings available for lease within a three mile radius of the area directly surrounding the building determined the market average lease rate was \$10.83 per square foot. The school lease price per square foot paid in fiscal year 2016 equated to \$26.91 per square foot. The resulting lease payment over market average in fiscal year 2016 alone was approximately \$867,000.⁵⁶

From July 1, 2004 through June 30, 2016 the lease payments have accounted for approximately 20.1% of all expenditures and 20.1% of all revenues received during this period.⁵⁷

⁵⁰ Per Lease Agreement Spreadsheet

⁵¹ Per Hamilton County Auditor

⁵² Per Orion Academy Lease Agreement

⁵³ Per Lease Agreement Spreadsheet

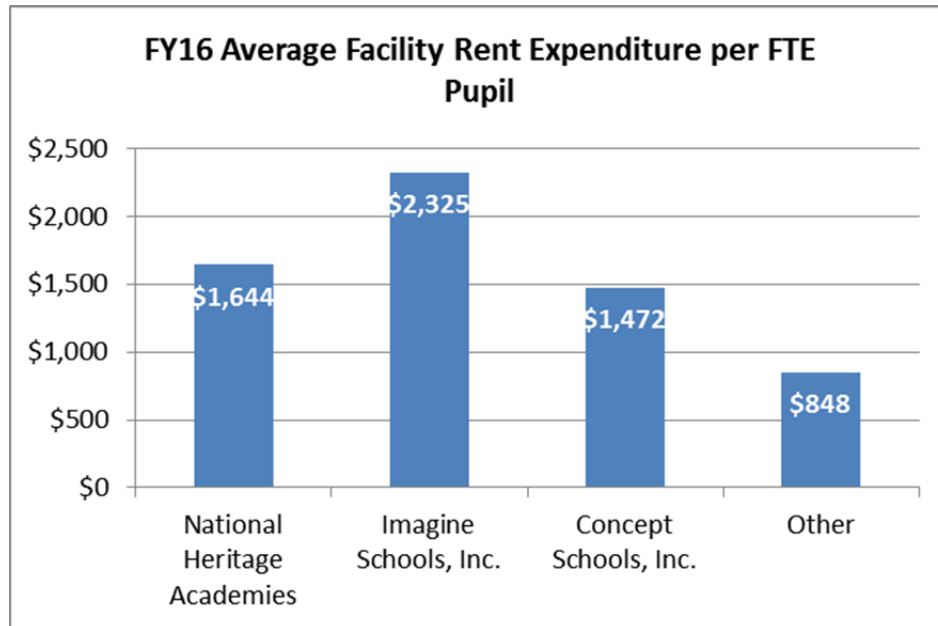
⁵⁴ Per Orion Academy and NHA Management Agreement

⁵⁵ Per Orion Academy Lease Agreement

⁵⁶ Per DAS Rent per Square Foot Spreadsheet

⁵⁷ Per Lease Agreement Spreadsheet

Effects of Spending on Academic Performance



The Average rent paid per pupil for National Heritage Academies, Imagine Schools, Inc, and Concept Schools was significantly higher than that of other sampled community schools in Ohio⁵⁸.

In fiscal year 2016 Imagine Schools, Inc. more than doubled the average rent paid per student for other community schools, however these excess expenditures had little to no effect on the quality of education provided to students. The control sample selected for other community schools used in the figure above consists of a sample of six randomly selected community schools in Ohio, not operating under a management agreement. Figures computed contain exclusively base rent payments and do not take into account additional expenditures the schools may have incurred for property maintenance, insurance, or taxes.⁵⁹⁶⁰

Schools report information annually to the Ohio Department of Education and they are graded based on six measures of performance. Not all measures of performance are applicable to all schools; however the four most commonly used measures are Achievement, Progress, Gap Closing, and K-3 Literacy. Of these four components across all community schools in Ohio, approximately 28 percent of scores were a C or above on average⁶¹. Report card data was reviewed for National Heritage Academies, Imagine Schools, Inc., Concept Schools, Inc., and sample of “Other” community schools to compare scores to the state averages and to determine the effect these potentially excessive lease expenditures may have had on the quality of education.

⁵⁸ Per review of random sample of community schools in Ohio

⁵⁹ Rent expenditures per school audited notes to the financial statements

⁶⁰ Per FY16 foundation funding FTE, located at education.ohio.gov

⁶¹ <http://education.ohio.gov/Topics/Data/Report-Card-Resources>

It was however discovered that schools of the three management companies and control sample reviewed performed comparably with the overall averages of all community schools in Ohio. National Heritage Academies and the sample selected of “Other” community schools performed slightly better than the average 28 percent with 34 percent of NHA’s and 32 percent of “other’s” subset scores rated C or above. Concept Schools, Inc. and Imagine Schools, Inc. performed slightly below average, both with 26 percent of subset scores rated C or above⁶².

Conclusion

Shortcomings in current Ohio law, lax oversight, and support programs geared toward community schools have allowed private companies to enter into questionable lease agreements with community schools to their advantage at the expense of those schools and the Ohio tax payers who fund their operation. A combination of those factors and the deficiencies we identified have afforded private parties an avenue to exploit community schools, diverting public dollars away from students. Notable findings include:

No Required Bidding Procedures: Although traditional school districts are required to follow certain bidding procedures under ORC 3313.46, this law does not apply to community schools. Currently, there are no laws in Ohio that require community schools to examine the market or to obtain competitive bids when identifying facilities for lease or purchase. This has resulted in community schools entering into lease agreements significantly above market rates. (See sections State Law and the Effects on Ohio Community School Facility Procurement and Market Analysis of leased Properties in Ohio)

Lack of Available Funding for Facility Purchase: Community schools are not offered many of the funding options available to traditional school districts that would afford community schools the ability to access debt options or make large purchases. These options not available to community schools include the ability to levy taxes, the ability to issue bonds, and the large majority of state sponsored facility assistance programs. (See Sections State Law and the Effects on Ohio Community School Facility Procurement and Community School Property Ownership Structure in Ohio)

Related Party Lease Agreements/Conflicts of Interest: National Heritage Academies and Imagine Schools, Inc. both had a direct financial interest in the companies their managed schools entered lease agreements with for all schools reviewed under those management companies. Employees of and persons with interest in New Plan Learning/Breeze, Inc., the parent company that the majority of Concept managed schools entered into lease agreements with, also served on the Board of schools while the schools were leasing from subsidiaries of New Plan Learning. (See Section Community School facility Lessor and Board Oversight of Facility Procurement and Lease Agreements) Board members with a vested interest in a company are prohibited from voting on any measures pertaining to that company in accordance with ethics laws.

⁶² Reportcard.education.ohio.gov

Lease Rates not Reflective of Market Rates: Schools operating under the management of two of the three management companies all had lease rates that exceeded local market rates by upward of 50-150%. This condition is further amplified by lease provisions which caused the majority of schools reviewed to be responsible for property related expenses normally incurred by the landlord in traditional lease agreements which including property taxes, insurance, building maintenance, and structural maintenance. (See Sections Market Analysis of Leased Properties in Ohio and Lease Provisions)

School District Unwilling to Lease Unused Facilities: The current education funding structure in Ohio is largely paid based on student enrollment, as a result community schools are often viewed as competition by school districts. The direct correlation between student enrollment and funding acts as a disincentive for school districts to lease or sell their unused properties to community schools. While other states have programs in place which encourage or require school districts to cooperate with community schools, Ohio does not currently have any laws or programs in place to encourage this. (See Section State Law and the Effects on Ohio Community School Facility Procurement)

Loopholes Utilized in ORC maximum debt term: ORC 3314.08(G)(1)(b) states “A school may also borrow money for a term not to exceed fifteen years for the purpose of acquiring facilities.” Although the debt term for community schools is restricted to a maximum of 15 years, there are no restrictions in place limiting maximum contract or lease term. Private companies not restricted by ORC are able to use this to their advantage in acquiring debt for the purchase of community school facilities.

In 2011 New Plan Learning issued a 30 year term bond series to refinance and renovate properties for four different Concept managed schools. Each school associated with the bond issuance signed a 30 year absolute net lease agreement to rent those facilities, which was used as security for the debt repayment in the bond agreement. Since the Ohio community schools were not directly the obligated party, the bonds were not subject to those ORC 3314 restrictions and therefore the schools and the bond agreement were both fully compliant.

At the end of the term, although these bonds will have been paid for in full exclusively through use of lease revenues paid by these four schools to New Plan Learning, the schools will receive no share of equity in the purchased property. (See Section Methods of Financing used by Management Companies and Other Private Related Companies)

Limitation of Board Oversight: Clauses contained in management agreements of National Heritage Academies and Imagine Schools Inc. delegate certain powers in regards to choosing a school facility to the management company. National Heritage Academies’ management agreement states the facility will be made available or leased by NHA for school use; Imagine Schools Inc. management agreement states Imagine Schools will assist in locating a facility for the school and emphasizes that Imagine Schools, Inc.’s must approve of said facility. (See Section Board Oversight of Facility Procurement and Lease Agreements)

Although the power of ultimate approval of choice and lease terms remain with the Board of Trustees, these clauses can place an assumed amount of trust in the hands of the management company, and blind the Board to any undisclosed transactions or relationships which may exist between the management company and the building owner and/or lessor. This includes related party transactions, sale and leaseback agreements entered into with Real Estate Investment Trusts and lease-sublease agreements between the management company and property owners with undisclosed rates that offer the management company basis to surcharge the school's rent as corporate lease guarantor which management companies are not required to disclose agreements entered into with other non-public entities as they are not subject to public record and ethics laws.

This condition is evident in an example discovered in which a school renegotiated its lease agreement directly with the property owner after severing ties with Imagine Schools, Inc who had formerly subleased the property to the school. Although the lease agreement was for the same property, the school's rent decreased over \$400,000 in the year immediately following the lease negotiation after removing Imagines' real estate management branch, Schoolhouse Finance, LLC, from acting as intermediary. (See Section Methods of Financing used by Management Companies and Other Private Related Companies)

Risk Hedging by Management Company: Community schools often lease their facilities indirectly from the property owners with the management company or management company real estate branch acting as intermediary, or corporate lease guarantor. The rationale behind this is since community schools are viewed as high risk lessees due to their risk of closure, a corporate lease guarantor provides the original lessor assurance that lease payments will be made. As fee for acting as corporate lease guarantor, the intermediary may surcharge lease rates.

Instances where this condition was present, and contracted community schools were closed were discovered. In each of these instances however management companies were able to absolve themselves of financial impact by immediately opening a new school in the same facility the following year under new sponsorship. (See Section Methods of Financing used by Management Companies and Other Private Related Companies)

Based on the findings from our analysis for this report and the issues faced by community schools, we recommend the State of Ohio establish a committee to study and analyze community school laws in other states and specific steps taken by those state legislatures to prevent or remedy these and similar issues from occurring.

Currently, there are no laws requiring community schools in Ohio to examine the market or obtain competitive bids when obtaining facilities, through purchase or lease or leasehold improvements. We recommend the legislature establish policy such as those utilized by the federal government to be performed by entities using state funding prior to entering into a lease agreement. The federal General Services Administration was established to help manage and support the basic functioning of federal agencies. The federal government under GSAM §570 generally requires that measures be taken to obtain competitive rates on leases and leasehold improvements. Additionally, GSAM §570.106 requires that in some instances, proposed acquisitions of leasehold improvements and leases in real property be advertised to the public depending on the size of the project. For contracts that exceed \$25,000 in value, it is required that the proposed lease or leasehold improvement be advertised if no exemption to this rule applies.

This section contains several provisions outlining the manner in which acquisitions are to take place, including market surveys, solicitations for offers, modifications, and even how to evaluate the offers. In our examination, we found no evidence that these steps are being taken by schools we evaluated. GSAM 570.2 provides an outline of simplified lease acquisition procedures required to be used by federal agencies when acquiring small leasehold interest in real property. These procedures include performing a market survey to identify potential locations meeting requirements; attempt to solicit competition, and lease negotiation, evaluation, and award. Should only one option present itself, documentation should be maintained explaining the lack of competition of bidding procedures.

Though management companies often dictate the day to day operations of community schools and are majorly funded by the public money paid to those schools they manage, ethics regulations and laws governing community schools do not directly apply to the management companies that run them. Current Ohio law requires very little transparency on behalf of the management companies, which has allowed them perform the majority of operations outside of the public eye and develop shady practices which skirt community school compliance regulations. As a result, we would further like to recommend legislation enact stricter standards guiding the operations of community school management companies and additional transparency requirements.

Further, it is recommended that the community school board of trustees be required to exercise power in reviewing and selecting the property, rather than delegating responsibility to the management companies. Boards should be reminded they must take the same care that an ordinary and prudent person would exercise under similar circumstances. Failure to exercise such care either through negligence or willful misconduct could result personal liability.

Referral for Further Review

The Auditor of State is referring the **Related Party Lease Agreements/Conflicts of Interest** issues identified above to the Ohio Ethics Commission for further review by that agency.



Dave Yost • Auditor of State

COMMUNITY SCHOOL FACILITY PROCUREMENT

FRANKLIN COUNTY

CLERK'S CERTIFICATION

This is a true and correct copy of the report which is required to be filed in the Office of the Auditor of State pursuant to Section 117.26, Revised Code, and which is filed in Columbus, Ohio.

Susan Babbitt

CLERK OF THE BUREAU

CERTIFIED
JANUARY 10, 2019