When School Management Companies Fail: Righting Educational Wrongs

KATHLEEN CONN[1]

INTRODUCTION

Increasing disaffection with American public education has spurred the rise of for-profit school management corporations that are acquiring pieces of the public education pie in two major ways. First, state departments of education or public school districts, acting under various "empowerment acts," contract with them to take over the operation of failing districts, or, second, they either obtain charters to operate public charter schools or subcontract to provide educational services to nonprofit companies that obtain such charters. In both cases, public money supports the privately operated "public" schools and goes into the coffers of the for-profit school management corporations.

Oversight and monitoring the delivery of educational services in school districts handed over to private management companies or in public charter schools operated by such private companies is problematic. Several districts have revoked contracts with school management companies when student scores on standardized tests failed to demonstrate significant improvement over a period of two or three years. "Turning around" a failing school or school district, however, can be a slow process under the best management. Conversely, leaving an ineffective school management company in control for an extended period of time may deprive students of educational opportunities that they cannot recoup.

Merely revoking a contract does not remedy damages incurred under the contract. Although an extensive literature detailing the rise of public charter schools has developed, few commentators helpfully address the possible causes of action or the remedies available to students disadvantaged by attending schools managed by or subcontracted to for-profit school management corporations. Such remedies are the focus of this paper.

1. Ph.D, J.D. Kathleen Conn is Supervisor of Science and Technology Education in the West Chester Area School District, West Chester, PA. A member of the Pennsylvania Bar, she is an educational consultant, a frequent presenter at national conferences, and author of many published articles on science education, curriculum design, and the Internet in schools. She would like to thank Adjunct Professor Robert J. Valihura, Jr. at Widener University School of Law for his encouragement and support.

Part I reviews the traditional system of public education in the United States, with control of educational decision-making in the hands of the individual states, and discusses the rise of school management corporations and how they acquire control of schools and school districts. Since many state charter school laws grant charters exclusively to nonprofit corporations, Part II examines the differences between nonprofit and for-profit corporations, especially with regard to the fiduciary duties of their managers and the differences in accountability to those who subsidize the companies. A nonprofit school management corporation generally exercises control over a single community school with a specific educational mission; the directors of these nonprofit corporations typically work closely with parents of school students, and are, therefore, more visible and accountable to stakeholders than their counterparts in for-profit companies. For-profit school management corporations generally pursue wider operational scope in order to realize profitability from economies of scale; directors are more autonomous and may even be invisible to stakeholders. Even with nonprofit corporations nominally in control of charter schools, however, the potential for significant abuse still exists when they subcontract educational services to for-profit corporations. Part II also briefly examines the conflict between for-profit school management and the education of students inherent in the shareholder wealth maximization principle of traditional corporate governance, and reviews the failure of "other constituency" statutes to resolve the conflict.

Part III examines indicators of school performance and discusses the standards of accountability available for judging the performance of school management companies. Part III also offers an evaluation of the largest for-profit school management company, Edison Schools, Inc.

Part IV reviews the alternative causes of action suggested by commentators to facilitate redress of educational wrongs to students committed in the charter schools and takeover contexts. Causes of action under prevailing legal theories appear to be inadequate or not really feasible, especially because the courts have traditionally disfavored causes for educational malpractice, and Part IV proposes a new cause of action in the corporate law setting. Since traditional corporate law causes of action are available only to shareholders of the corporation, however, Part IV proposes that school management corporations must gift stock in their corporations to students electing to attend their schools, to be held in trust by their parents or guardians. Once students are shareholders in the corporations that assume the obligation to educate them, they have a voice in the corporations and the possibility of holding the corporations accountable under fiduciary principles. Part IV examines certain remedies that would theoretically be available under corporate law in suits against the school management corporations, focusing particularly on rescissory damages as the most suitable mechanism for redressing educational wrongs.

Part V concludes with a forecast of the future of school management corporations in education.

I. THE PUBLIC SCHOOL SYSTEM OF EDUCATION

Education and corporate law share billing as two of the primary drivers of a society's economic productivity, according to an increasing number of legal scholars and economists.[2] While the United States' law regulating the conduct and operation of business organizations has become a *de facto* world standard,[3] the United States system of K-12 public education has not.[4] Failing public schools and criticisms of school district accountability have led to the rise of school management corporations eager to exploit public tax dollars to fund their own education agendas.[5] Many of these are nonprofit corporations with idealistic leaders, but the largest and most successful in garnering the educational market share are publicly-traded, for-profit corporations promising financial returns to their shareholders, not to students.

A. States' Responsibility for Public Education

Public education is traditionally the province of the state.[6] Although not recognized as a fundamental right triggering strict judicial scrutiny,[7] the Supreme Court acknowledged education as "one of the most important services performed by the state."[8] States perform their educative role through state boards of education, but delegate day-to-day administrative authority to local school boards whose members are generally elected in democratic elections.[9] States

2. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1287, n.1 (2001).

3. *Id.* at 1288.

4. *See* OFFICE OF EDUCATIONAL RESEARCH AND IMPROVEMENT, U.S. DEP'T OF EDUC., Third International Mathematics and Science Study (TIMSS) and the repeat study (TIMSS-R) indicating that the academic performance of American K-12 students in mathematics and science is below the level of students in most of the industrialized nations of the world, *available at* http://www.nces.ed.gov/timss (1999).

5. *See, e.g.*, Catherine Gewertz, *Dayton Feels the Heat From Charter Schools*, EDUC. WK, Apr. 24, 2002, at 1.

6. The United States Constitution does not explicitly authorize Congress to provide for education; therefore, under the Tenth Amendment, that power resides with the states. Every state constitution specifically addresses the state's responsibility to provide a system of public education. MARTHA M. MCCARTHY *ET AL.*, PUBLIC SCHOOL LAW: TEACHERS' AND STUDENTS' RIGHTS 2, (4th ed. 1998).

7. San Antonio Indep. Sch. Dist. v. Rodriguez, 411 U.S. 1 (1973) (holding that there is no explicit or implied fundamental right to education under the U.S. Constitution).

8. *Id.*

9. MCCARTHY, *supra* note 6, at 5.

have a duty to support public schools, but they may not directly support nonpublic, i.e., sectarian, schools.[10] They may, however, support fully or partially autonomous school entities created by a contract between the school's organizers and a sponsor identified in the enabling legislation.[11] Such school entities are called public charter schools, and by the end of 2001, thirty-seven states, the District of Columbia and Puerto Rico had enacted charter school laws enabling the creation of such charter schools.[12] By April 2002, over 2,300 charter schools were operating in thirty-four states and the District of Columbia, with over 575,000 students enrolled.[13]

In exchange for a legislatively regulated and curriculum-specific performance contract, charter schools receive waivers exempting them from many of the restrictions and responsibilities of traditional schools.[14] If a state releases a charter school from too many restrictions, however, a lawsuit may result.[15] Although most states have enacted "strong" charter school laws, i.e., laws that give charter schools considerable operational autonomy with the hope that, freed from the traditional educational bureaucracy, they will achieve significant educational reforms,[16] state legislatures must reconcile the language in the

10. The state may use public funds to provide services to students attending nonpublic schools, but not to the institutions themselves. For example, the Supreme Court upheld the right of the state to provide transportation services to nonpublic school students under the child benefit doctrine. Everson v. Bd. of Educ., 330 U.S. 1 (1947). Similarly, states may loan textbooks, and provide counseling and special education services to children attending nonpublic schools. MCCARTHY, *supra* note 6, at 60-66. *See also* Frank R. Kemerer & Catherine Maloney, *The Legal Framework for Educational Privatization and Accountability*, 150 EDUC. L. REP. 589, 592 (2001).

11. Preston Green, *Are Charter Schools Constitutional?: Council of Organizations and Others for Education about Parochiaid v. Governor*, 125 EDUC. L. REP. 1, 1 (1998).

12. Preston Green, III, *Charter Schools and Religious Institutions: A Match Made in Heaven?*, 158 EDUC. L. REP. 1, 1 (2001). By April 2002, thirty-eight states had adopted charter school laws. *See* statistics complied by the Center for Education Reform, a nonprofit educational watchdog group based in Washington, D.C., *at* http://edreform.com/pubs/chglance.htm (last modified April 16, 2002).

13. *See* http://edreform.com/pubs/chglance.htm (last modified April 16, 2002).

14. Green, *supra* note 12, at 1-2.

15. Green, *supra* note 11, at 2, 6-8. The Council of Organizations and Others for Education about Parochiaid, Inc., an advocacy group supporting the separation of church and state, sued Michigan Governor John Engler, challenging the constitutionality of the 1993 Michigan Charter School Act. Reversing the two lower courts' determinations that charter schools must be under the immediate, exclusive control of the state, the Michigan Supreme Court set out indicia of state control that were sufficient to withstand constitutional challenge, including the application-approval process, the power of the authorizing entity to revoke the school's charter, the power of the state to select the Board of Directors, and the applicability of other sections of the state education code. *Id. See also* Wilson v. State Bd. of Educ., 75 Cal. App. 4th 1125 (1999), where the court upheld the constitutionality of California's Charter Schools Act against a challenge by residents and taxpayers, stating that the legislature had provided adequate safeguards in the Act to prevent abuse of delegated power.

16. Jennifer T. Wall, *The Establishment of Charter Schools: A Guide for Legislatures*, 1998 BYU EDUC. & L.J. 69, 69 (1998).

charter school act with the extent of delegation of educational duties allowable under their state constitutions.[17]

Although new charter schools continue to open their doors, charter schools have a relatively high failure rate compared to traditional schools. By the beginning of the 1999-2000 academic year, over fifty-nine charter schools had closed their doors, nearly 4% of the 1400 charter schools that had opened by that date.[18] By December 2000, the number of failed charter schools had risen to eighty-six, with another twenty-six consolidated into their local school districts for various reasons.[19] Causes of the failures were mainly financial, with schools either growing too fast and becoming fiscally unstable or failing to bring in enough revenue because of inadequate enrollment.[20] However, mismanagement, loss of building leases, and failure to provide promised educational programs also caused closures.[21] While supporters of the charter school movement may try to portray charter school closures as positive signs of the accountability measures in place for such schools, school closures mean disruption of the educational process for students, inconvenience for parents, and headaches for the public school districts to which the displaced students return.

State takeovers of school districts or other transfers of control of existing public school entities to school management corporations do not occur under charter school acts. Many states have empowerment acts that allow districts to enter into performance contracts with school management companies.[22] The public school administration, or the state, can terminate the management company's contract if dissatisfied, and resume school operations.[23] Involuntary school takeovers are relatively rare.[24] The schools involuntarily privatized are usually not only educationally inadequate, but also financially strapped.[25] Of all the districts privatized to date, for-profit companies manage relatively few. In December 2001, the state of Pennsylvania took over the Philadelphia School District, the eighth-largest school district in the nation and the largest district

17. *Id.* at 71.

18. *See* NATIONAL STUDY OF CHARTER SCHOOLS, U.S. DEP'T OF EDUC., *The Expanding Charter School Movement* (January 2000), *available at* www.ed.gov/pubs/charter4thyear/a.html (last visited June 12, 2002).

19. *See* CHARTER SCHOOLS TODAY: CHANGING THE FACE OF AMERICAN EDUCATION, CENTER FOR EDUCATION REFORM, *Closures: The Opportunity for Accountability* (January 2001), *at* http://www.edreform.com/pubs/cs_closures.htm (last visited June 12, 2002).

20. *Id.*

21. *Id.*

22. Cheryl L. Wade, *Lessons from a Prophet on Vocational Identity: Profit or Philanthropy?*, 50 ALA. L. REV. 115, 117 (1998).

23. *Id.* at 118.

24. CAROL ASCHER, NORM FRUCHTER, & ROBERT BERNE, HARD LESSONS: PUBLIC SCHOOLS AND PRIVATIZATION, The Century Foundation (1996), *at* http://www.tcf.org/Publications/Education/Hard_Lessons/Chapter1a.html.

25. Wade, *supra* note 22, at 119.

ever to be taken over by a state,[26] and established the Philadelphia School Reform Commission to run the district. In March 2002 the Commission named publicly traded, for-profit Edison Schools, Inc. as lead consultant in the overhaul and anticipated privatization of the 200,000-student district.[27] Total privatization of the district did not materialize. In fact, Edison Schools, Inc. received contracts to operate only twenty schools, instead of the forty-five it had anticipated. Edison's stock price plummeted with the announcement of the reduced number of contracts and, subsequently, numerous inquiries about inflated earnings reports were filed with the Securities and Exchange Commission.[28]

B. Private Sector Control

In many states, a corporation managing schools involuntarily taken over by the state or one managing voluntarily organized charter schools can be either a nonprofit entity, like an "intermediate unit" or a college or university, or one of several large for-profit school management companies.[29] About 10% of the country's approximately 700 charter schools are managed by for-profit companies.[30] Even if the state's charter school act provides that a corporate charter applicant must be a nonprofit entity, as, *e.g.*, Pennsylvania's Act does,[31] the nonprofit entity may subcontract with a for-profit corporation who will then supply educational services for the charter school.[32]

---

26. Catherine Gewertz, *It's Official: State Takes Over Philadelphia Schools*, EDUC. WK., Jan. 9, 2002, *available at* http://www.edweek.org/ew/newstory.cfm. Other states have seized smaller districts or part of districts, *e.g.*, New Jersey seized the Jersey City, Paterson and Newark School District between 1989 and 1995. *Id.*

27. Susan Snyder, *Lead School Role Expected for Edison*, PHILA. INQUIRER, Mar. 26, 2002, at A1. *See* also, Susan Snyder & Martha Woodall, *Board's Vote Starts Plan for Privatization*, PHILA. INQUIRER, Mar. 27, 2002, at A1.

28. *See* Martha Woodall, *Edison's Stock Dive Raises Concerns*, PHILA. INQUIRER, May 8, 2002, at 1. *See also* Martha Woodall & Susan Snyder, *Edison Hit by Fall in Stock Price and Suits after Inquiry*, PHILA. INQUIRER, May 16, 2002, at B2.

29. Commentator Cheryl Wade takes a pessimistic view of for-profit school managers, equating the vulnerability of students in for-profit schools to that of patients in for-profit hospitals, criminals in privatized jails, and those dependent on privatized distribution of social service benefits. Cheryl L. Wade, *For-Profit Corporations that Perform Public Functions: Politics, Profit, and Poverty*, 51 RUTGERS L. REV. 323, 325-26, 335 (1999).

30. NATIONAL EDUCATION ASSOCIATION, *Charter Schools Run by For-Profit Companies*, *at* http://www.nea.org/issues/corpmngt/corpchar.html (last visited June 1, 2002). Twelve companies nationwide manage for-profit charter schools. *Id.*

31 *See* Pennsylvania's Charter School Act §1717-A (Establishment of a Charter School), 24 P.S. §§ 17-1701-A to 17-1732-A (1997).

32. State laws regulating for-profit charter schools differ greatly from state to state. Some states grant charters directly to the for-profit entity; some [like Pennsylvania] require that the school itself be a nonprofit entity that hires the services of a for-profit school management company. Kathi Karsnitz, *Charter Schools: Mile Markers on the Road of Reform or a Dead End for Public Education?* 16 DEL. LAW. 5, 7 (1998). The West Chester (Pennsylvania) Area School District refused to grant a charter to Collegium Charter School, a nonprofit corporation seeking to open a charter school within the geographic boundaries of the district.

For-profit school management corporations are definitely interested in supplying educational services and managing schools. Education is big business. K-12 education, the largest segment of the education market, is a $348 billion per year industry, as large as the domestic auto industry.[33] Public schools spend about $80 billion on non-educational purchases of goods and services, many of these under contract with private providers.[34]

II. SCHOOL MANAGEMENT COMPANIES

K-12 public schools do not charge tuition. Accessibility is the cornerstone of American public education. When the state steps in to take control of a failing school or school district, students continue to receive educational services without charge, even if a for-profit corporation delivers those services. The same is true in the public charter school setting.[35] Charter schools receive all or part, depending on the contract terms, of the per pupil allocation[36] that would

---

Collegium had contracted with Mosaica Corporation, a for-profit corporation with headquarters in California, to provide core instruction in Mosaica's Paragon Curriculum. Collegium sued the district. West Chester Area Sch. Dist. v. Collegium Charter Sch., 760 A2d 452 (Pa. Cmwlth. 2000), *reargument denied*, Nov. 1, 2000, *appeal granted*, 782 A.2d 552 (2001).

33. NATIONAL EDUCATION ASSOCIATION, *Education, Investors, and Entrepreneurs: A Framework for Understanding Contracting Out Public Schools and Public School Services*, *at* http://www.nea.org/issues/corpmngt/analys2.html (last visited June 1, 2002). *See also* Lewis D. Solomon, *The Role of For-Profit Corporations in Revitalizing Public Education: A Legal and Policy Analysis*, 24 U. TOL. L. REV. 883, 888 (1993), asserting that expenditures for K-12 public education represent over 4% of the U.S. Gross National Product.

34. Commentator Solomon argues that contracting out public services to private firms offers the advantages of increased efficiencies, lower costs, higher quality services, flexibility, and greater incentives for innovation. Solomon, *supra* note 33, at 914-15.

35. Preston Green, III, *Racial Balancing Provisions and Charter Schools: Are Charter Schools Out on a Constitutional Limb?*, 2001 BYU EDUC. & L.J. 65, 68 (2001).

36. "Per pupil allocation" is a figure that represents the average amount a public school district spends to educate one regular education student per year, minus the cost of transportation and school district debt service. Although state charter school laws differ in details, a public school district must generally pay the per pupil allocation to the charter school annually for each student who enrolls in the charter school, regardless of how much the charter spends per student each year. Districts that have a healthy tax base and spend more money per student per year pay more "tuition" per student who enrolls in a charter school. For example, the West Chester Area (Pennsylvania) School District pays over $6,000 per year per student who attends a charter school instead of her "home" school. The "tuition" for each special education student is nearly twice that amount. *Personal Communication*, Suzanne Moore, CFO, West Chester Area School District (April 9, 2002). Another Pennsylvania school district, the struggling Chester Upland School District, had such an increased number of district students enroll in charter schools in the 2001-02 school year that the district had a budget deficit of more than $4.5 million for the year. In a district whose total enrollment was 7,500 students, 1,590 students elected to attend charter schools, precipitating the budget crisis. Dan Hardy, *Schools Deficit Blamed on Charter Enrollments*, PHILA. INQUIRER, Apr. 8, 2002, at B8. The Dayton, Ohio public school system has experienced an even larger drain of resources, with fifteen percent of its school-age population attending charter schools, siphoning $19 million from the school district budget and thirty-three percent of its students. Gewertz, *supra* note 5, at 1.

otherwise have gone to the home school district if the student had enrolled in her district of residence.[37] Each charter school can potentially claim 75% or more of the state's per pupil allocation for each student who enrolls in the school.[38] State Charter School Laws do not generally require a showing that charter schools actually expend the entire amount of state allocations on educational costs.[39]

Perhaps the largest disparity between the amount of the charter school's per pupil allocation and the actual expenditure for direct instruction occurs in public cyber charter schools. Public cyber charter schools use the Internet or other distance learning technology as the primary mode for delivery of academic instruction to students who participate in or receive instruction at their homes or in other non-traditional education settings. In many states, they recruit students regionally, and students may enroll in more than one cyber school.[40] Because cyber schools typically have few staff members, costs per pupil are low by comparison to traditional education costs. Still, most states have no accountability measures in place to ensure that cyber schools spend public money on education of students. Pennsylvania alone has over 2000 students enrolled in cyber charter schools, and has engaged in a protracted legal battle over funding with the state's largest cyber school, Einstein Academy Charter School, after parents complained about lack of textbooks and equipment.[41] The state has reached a settlement with the school, but other disputes are certain to arise.

A. Nonprofit versus For-profit School Management Companies

Without effective accountability measures in place, for-profit school management corporations appear to have free rein to divert public money their way. Abuses can and do occur in nonprofit school management companies. On the whole, however, the public perception of dedicated parents and educators band-

37. *See also* Andrew Broy, *Charter Schools and Education Reform: How State Constitutional Challenges Will Alter Charter School Legislation*, 79 N.C.L. REV. 493, 512-14 (2001).

38. *Id.* at n.120. The per pupil reimbursements are usually limited to not less than 75% nor greater than 125% of the state allocation per pupil.

39. Jennifer Wall describes states' general lack of plans to ensure accountability of charter schools. Wall, *supra* note 16, at 74.

40. Pennsylvania cyber charter schools are typical of those in many states. Pennsylvania School Boards' Association White paper on Cyber Schools, *available at* http://www.psba.org/governmental/Cyber_Sch_White.pdf (last visited Mar. 20, 2002).

41. Martha Woodall, *Future of Cyber Charter School Is Seen as More Secure*, PHILA. INQUIRER, Mar. 29, 2002, at B5. Einstein Academy is a nonprofit corporation founded by Mimi Rothschild; Ms. Rothschild also owns the for-profit corporation Tutorbots, Inc., which up until recently held a contract to manage Einstein. *Id.* Pennsylvania State Department of Education Secretary Charles Zogby withheld payments to Einstein Charter while the dispute raged, and Einstein lost its Internet service provider. As a temporary measure, Einstein sent students copies of "freebie" discs from America Online for 1,000 hours of free AOL service. Martha Woodall, *Cyber School to Lose its Internet Connection*, PHILA. INQUIRER, Mar. 7, 2002, at B3.

ing together to form selfless neighborhood nonprofit charter schools to deliver educational services to a group of students whom public education has failed is a reality. Many nonprofit public charter schools serve traditionally underserved communities or populations commendably.[42] University-sponsored charter schools have pioneered exemplary educational reforms.[43] However, when state charter school laws allow large for-profit corporations to manage schools, or when nonprofit managers contract with for-profit companies to provide educational services, the specter of for-profit companies misappropriating tax dollars is especially frightening.

Although forty-six states plus the District of Columbia have separate statutes governing corporations, whether nonprofit or for-profit,[44] corporations overall bear more resemblance to each other than their different tax treatment might indicate.[45] Economic forces motivate both,[46] and one of the most powerful economic forces is the desire for a reputation that inspires future trade or association.[47] Both nonprofits and for-profits want to be seen as "doing well."

Both nonprofits and for-profits have transaction costs, including costs of acquiring information and contracting, as well as agency costs, including supervisory costs and trust-building costs.[48] Although a nonprofit corporation has no legal "owners," it does have the economists' characteristics of ownership: the right to profits, the right to control and utilize assets, and the right to alienate.[49] A nonprofit corporation can make profits; it simply cannot distribute the profits.[50] A nonprofit has no shareholders; it must reinvest profits or spend them.[51] The lack of shareholders and the restriction on distribution of profits

42. Press Release, Center for Education Reform, New Data Makes Case for Charter Schools (Sept. 2, 2001), *at* http://www.edreform.com/press/2001/newdate.htm (last visited June 1, 2002).

43. National Education Association *at* http://www.nea.org/partners (last visited June 1, 2002). The Massachusetts Pioneer Institute services independently-managed public schools and has sponsored many innovative charter school structures. *See* Massachusetts Charter School Resource Center at Pioneer Institute *at* http://www.pioneerinstitute.org/csrc/charter_info.cfm (last visited June1, 2002). *See also Build a Public School of Uncompromising Excellence,* Building Excellent Schools Fellowship Program, *at* http://www.buildingexcellentschools.org (last visited June 1, 2002).

44. Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400 n.42 (1998). Delaware is one of four states whose general corporation law covers both.

45. Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 457 (1996). *See also* Richard C. Allen, *Due Diligence When a Party Is a Nonprofit, in* DUE DILIGENCE IN MASSACHUSETTS, MA-CLE 8-I (2000).

46. Garry W. Jenkins, *The Powerful Possibilities of Nonprofit Mergers: Supporting Strategic Consolidation through Law and Public Policy*, 74 S. CAL. L. REV. 1089, 1090-91 (2001).

47. Brody, *supra* note 45, at 461.

48. *Id.* at 462-63, 471-473.

49. *Id.* at 466.

50. *Id.* Economists assert that the non-distribution constraint acts as a weak substitute for shareholders. *Id.* at 470.

51 *Id.* at 491. The "mom and pop" image of nonprofits is completely outdated. By the end of the 1990s, nonprofits controlled more than $1 trillion in assets and earned nearly $700 billion annually, approximately 10% of the gross national prouct. *See* Jenkins, *supra* note 46, at 1094.

makes the issue of control of a nonprofit of paramount importance. Nonprofit corporations may have members with rights to elect the board of directors, but most do not, and the board becomes self-perpetuating.[52] Moreover, private persons often lack standing to sue the directors of nonprofit corporations.[53] Recent statutes have tended to enlarge the class of persons with the requisite standing, but findings of liability in the nonprofit sector hardly ever result in consequences more severe than admonishment or removal.[54] Rather than punishment, reform of the corporation's conduct is generally the goal.[55]

B. Fiduciary Duties in Nonprofit and For-profit Corporations

State laws invest the directors of both nonprofits and for-profits with fiduciary duties.[56] The fiduciary duties of nonprofit directors compel them to persevere in the purposes for which the nonprofit entity was created,[57] although amending a nonprofit's charter is relatively easy.[58] However, nonprofit directors also assume fiduciary duties of care and loyalty.[59] The definitions of these duties in the nonprofit context are similar[60] to those in the for-profit context. The duty of care requires diligence in examining corporate matters and exercise of independent judgment; the duty of loyalty prohibits self-dealing or conflicts of interest.[61] However, the Uniform Management of Institutional Funds Act[62] allows directors of nonprofit corporations to consider social implications in making investment decisions, and to employ both social and financial criteria to choose investments that align with their ethical concerns.[63] This contrasts with the shareholder wealth maximization principle in the for-profit sector. The shareholder wealth maximization principle is problematic in a for-profit school management corporation because the directorial imperative to deliver maxi-

52. Brody, *supra* note 44, at 1426.

53. The state attorney general is the watchdog, but he usually steps in only in extreme cases of malfeasance. *Id.* at 1430-31. *See also* Brody, *supra* note 45, at 486. *See generally* Mary G. Blasko *et al.*, *Standing to Sue in the Charitable Sector*, 28 U.S.F.L. REV. 37 (1993).

54. Brody, *supra* note 44, at 1432-34.

55. *Id.* at 1409.

56. *Id.* at 1406.

57. Jenkins, *supra* note 46, at 1118.

58. Brian F. Havel, *Introduction to Corporations and Trusts*, SE61 ALI-ABA 89, 101 (2000).

59. *Id.* at 95-99. *See also* Dean Papademetriou, *Legal Issues for Nonprofit Cultural Organizations: A Primer for Lawyers and Board Members*, 44-OCT B.B.J. 12, 26-27 (2000).

60. Havel suggests that nonprofit directors are held to a lower standard of the duty of care than directors of a for-profit corporation. Havel, *supra* note 58, at 97. *See also* Brody, *supra* note 44, at 1412 (discussing the Revised Model Nonprofit Corporation Act).

61 Papademetriou, *supra* note 59, at 26-27.

62. 7A U.L.A. 316 tbl. (Supp. 1997). Over 39 states and the District of Columbia have adopted the Act.

63. Lewis Solomon & Karen C. Coe, *Social Investments by Nonprofit Corporations and Charitable Trusts: A Legal and Business Primer for Foundation Managers and Other Nonprofit Fiduciaries*, 66 U. MO. L. REV. 213, 231 (1997).

mum profits to shareholders may force directors to choose the lowest cost alternatives in delivery of educational materials and services to students.[64]

Under the Uniform Management of Institutional Funds Act, the standard of review applicable to directorial decisions in the nonprofit setting is the business care rule,[65] similar to the familiar business judgment rule applicable in the for-profit context except that directors retain the right to consider social and political conditions as investment criteria.[66] No similar proviso exists in any of the three standards of review of decisions by directors of for-profit corporations. The three paradigmatic standards, enunciated by the Court of Chancery and the Supreme Court of Delaware in a series of decisions beginning in 1985, namely the business judgment rule, the entire fairness test, and the enhanced scrutiny review,[67] oblige directors to make rational and selfless judgments that are in the best interests of the corporate entity and its shareholders in any given circumstances.[68]

Despite the fact that nonprofit corporations operate under the dual constraints of fiduciary duties and non-distribution of earnings, breaches of the public trust do occur. The Regents of New York removed from office all but one of the directors of Adelphi University, after they found the board had breached its duty of care in fixing the salary and overall compensation of its President, Peter Diamondopoulos, and its duty of loyalty by entering into undisclosed and lucrative insurance and advertising contracts with firms owned by board members.[69] In 1994, the New York Attorney General's office indicted three directors of the United Way of America (UWA) for wire and mail fraud, money laundering, and other felonies. The three were convicted of stealing more than $600,000 in UWA funds by siphoning money into spin-off corporations that they used to purchase luxury personal goods and expensive trips.[70] These exam-

64. For a discussion of fiduciary duties of directors of for-profit corporations and the shareholder wealth maximization paradigm in the school management context, *see* Kathleen Conn, *For-profit School Management Corporations: Serving the Wrong Master*, 31 J.L. & EDUC. 129 (2002).

65. Eileen M. Evans and William D. Evans, *"No Good Deed Goes Unpunished:" Personal Liability of Trustees and Administrators of Private Colleges and Universities*, 33 TORT & INS. L.J. 1107, 1115 (1998) (citing Louisiana World Exposition v. Federal Insurance Co., 864 F.2d 1147 (5th Cir. 1989), and Boston Children's Heart Foundation, Inc. v. Nadal-Ginard, 73 F.2d 429 (1st Cir. 1996)).

66. Solomon & Coe, *supra* note 63, at 231-32. For example, directors can refuse to invest in companies dealing with repressive regimes if political rights are an important issue for their corporation. Solomon & Coe argue that social investing *per se* does not negatively impact the financial bottom line of companies that embrace the practice.

67. Allen, Jacobs & Strine, Jr., *supra* note 2, at 1292-1311.

68. For a discussion of case law indicating to whom directors of for-profit corporations owe fiduciary duties, *see* Conn, *supra* note 64.

69. *See* Adelphi v. N.Y.S. Bd. of Regents, 647 N.Y.S.2d 678 (N.Y. Sup. 1996), *aff'd by* 652 N.Y.S.2d 837 (N.Y. A.D. 1997); Vacco v. Diamondopoulos, 715 N.Y.S.2d 269 (N.Y. Sup. 1998).

70. The United Way litigation is extensive, much of it focusing on President Aramony's claims pertaining to statutes of limitations, ERISA and other reimbursement issues. For a concise statement of the facts of the case, *see* Aramony v. United Way of America, 969 F. Supp. 226 (S.D.N.Y. 1997).

ples present cautionary tales for the nonprofit school management context, but they are, on the whole, exceptions rather than the rule.

In both *Adelphi* and *United Way,* government actors were the watchdogs that barked at directors' breaches of fiduciary duties. When directors of for-profit corporations breach fiduciary duties, disadvantaged shareholders must seek redress either in direct, derivative or class action suits. If state or local governments require that school management companies organize as nonprofit corporations, government entities, as well individuals, bear direct responsibility for monitoring their performance. Because of the favorable tax treatment nonprofits can claim, the Internal Revenue Service also closely monitors their financial returns.[71]

If, however, for-profit corporations contract to manage public schools, either directly or indirectly by subcontracting to provide services to non-profits who acquire charters, only the shareholders of the for-profit corporation may bring suit to redress directors' breach of fiduciary duties. Shareholders can claim to be the beneficiaries of directors' fiduciary duties by virtue of their status as owners of the corporation separated from control and as residual claimants.[72] Students in schools managed by for-profit school management companies, although dependent on the educational services provided by the company, are not the beneficiaries of the fiduciary duties of the corporations' directors. Neither are their parents. The directors of a for-profit corporation owe duties of care, loyalty and good faith exclusively to the corporation[73] and its shareholders.[74] Under settled principles of corporate law in most states, directors owe no fiduciary duties to other constituencies such as students, parents, employees, or commercial suppliers.[75]

---

71. Brody, *supra* note 44, at 1409.

72. Rachel Weber, *Why Local Economic Development Incentives Don't Create Jobs: The Role of Corporate Governance*, 32 URB. LAW. 97, 107-09 (1998). *See also* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423-24 (1993).

73. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (where the court spoke of the "corporate enterprise" and the "corporation and its shareholders"). *See also, e.g.*, Malone v. Brincat, 722 A.2d 5 (Del. 1998) and Jackson Nat. Life Ins. Co. v. Kennedy, 741 A.2d 377 (Del. Ch. 1999).

74. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986), the Supreme Court of Delaware limited the Unocal prescription that directors consider the "corporation" as well as its shareholders, ruling that in a sale of the company directors must consider only shareholders. Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1282 n. 29 (Del. 1989) reiterated the *Revlon* limitation, stating that a "reasonable relationship to general shareholder interests" was necessary when directors considered non-shareholders' interests.

75. *See* Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 36 (1996), arguing for special duties toward shareholders because of the vulnerability of their equity interests.

C. Other Constituency Statutes

Many states have attempted to impose on directors of for-profit corporations fiduciary duties to constituencies other than their shareholders.[76] Most of these "other constituency" statutes have failed to accomplish their goals,[77] either because they are permissive statutes[78] or because they lack enforcement mechanisms.[79] Pennsylvania, one of the first states to enact an "other constituency" statute, has had several challenges to the statute's constitutionality. The first occurred in a derivative action to enjoin the department store giant Strawbridge and Clothier from presenting to shareholders a stock reclassification plan that would have defeated a raider's tender offer.[80] The court refused to grant the injunction, holding that Strawbridge directors rightly considered the potential effect a successful tender offer would have had on the company's employees, customers, and community.[81] More recently, application of the Pennsylvania statute was upheld in a 1996 court decision in which Conrail sought a friendly merger with CSX Corporation, rejecting a more lucrative Norfolk Southern bid that cost shareholders $1.5 billion.[82] Conrail argued, and the court accepted, that, under the Pennsylvania statute, corporations have the right to consider constituencies other than shareholders and shareholders' financial interests in making business decisions.[83]

Baron and *Conrail*, however, are exceptions to the rule.[84] Attempts to apply permissive other constituency statutes through litigation have failed more often than they have succeeded.[85] One state, Connecticut, has enacted a mandatory other-constituency statute, compelling directors to consider stakeholder inter-

76. Joseph Biancalana, *Defining the Proper Corporate Constituency: Asking the Wrong Question*, 59 U. CIN. L. REV. 425, 434-35 (1990).

77. Other consitutuency statutes were largely a response to the hostile takeover hysteria of the mid-1980's. Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85 (1999). Delaware is one of the states that has declined to pass such a statute, and Nebraska has repealed its statute, bringing the total number of states currently operating under such statutes to twenty-nine. *Id.* at 95.

78. Wai Shun Wilson Leung, *The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-shareholder Interests*, 30 COLUM. J. L. & SOC. PROBS. 587, 614 (1997).

79. *Id.* at 620-21.

80 Baron v. Strawbridge, 646 F. Supp. 690 (E.D. Pa. 1986).

81. *Id.* at 697.

82. Southern v. Conrail, Inc., C.A. No. 96-CV-7167 (E.D. Pa. 1996).

83. *Id.*

84. Van Der Weide asserts that when Pennsylvania adopted its "other constituency" statute, companies opting out of the statutory provision experienced abnormal gains. Van Der Weide, *supra* note 75, at 69. Van Der Weide quotes a study by Samuel Szewczyk & George Tsetsekos estimating that the Pennsylvania statute cost shareholders of Pennsylvania corporations losses of $4 million dollars. *Id.* at 69 n.235. Van Der Weide also asserts that virtually everything that state legislatures have accomplished with other-constituency statutes can be accomplished through amendments of corporate charters. *Id.* at 75. *See also* Springer, *supra* note 77, at 123.

85. *See* Leung, *supra* note 78, at n.154.

ests in decision-making;[86] but this statute, too, has failed to make an impact, because it lacks an enforcement mechanism.[87]

In summary, case law and statutes, despite the movement to legitimize other-constituency statutes, make clear that directors' duties of loyalty flow exclusively to shareholders. In the context of public education, the primacy of shareholder wealth maximization means the directors of a for-profit school-management corporation owe fiduciary duties of loyalty to one constituency only: shareholders. For students disadvantaged by for-profit school management corporations to have standing to sue corporate directors for breaches of fiduciary duties under state corporate law statutes, they must be shareholders. Even in nonprofit school management corporations, students still need protection.

III. MONITORING THE PERFORMANCE OF SCHOOL MANAGEMENT COMPANIES

A. Indicators of Educational Performance

In cases of school takeovers, school management corporations contract with school districts or the state to perform specified educational duties. Similarly, such corporations contract with chartering entities to operate public charter schools, or subcontract to provide services to nonprofit corporations who have obtained charters.[88] Determining whether a school management corporation lives up to the terms of its contract can be difficult. While most states require that contract terms specify a mission statement and curricular goals,[89] the indicators of school performance are myriad. From an educational standpoint, key performance indicators may include students' performance on state-mandated examinations, overall student enrollment, average daily student attendance and truancy rates, serious disciplinary incidents, and competent performance of routine administrative tasks, like record keeping and budget management.[90] A market approach relies on parents' ability to choose the schools to which they send their children.[91] However, deciding whether schools or teachers are pro-

86. CONN. GEN. STAT. §33-313(e).

87. Leung, *supra* note 78, at 620-21.

88. Kemerer & Maloney report that as of the beginning of 2001, about 12% of public charter schools are operated by private organizations. Kemerer & Maloney, *supra* note 10, at 605.

89 Julie F. Mead and Preston C. Green, *Keeping Promises: An Examination of Charter Schools' Vulnerability to Claims for Educational Malpractice*, 2001 BYU EDUC. &. L.J. 35, 48-54 (2001).

90. *See, e.g.*, Dan Hardy, *Poor Marks for Edison by Chester Upland*, PHILA. INQUIRER, May 15, 2002, at B1, *available at* http://www.philly.com/mld/inquirer/living/education/3266143.htm (last visited May 17, 2002).

91. Kemerer & Maloney, *supra* note 10, at 589.

viding quality education is so fraught with ambiguities that courts do not generally recognize causes of action for educational malpractice except in certain specific special education contexts.[92]

The non-distribution constraint on nonprofit school management corporations gives some assurance, albeit limited, that nonprofits will channel funds into educational efforts. Problems of accountability are exacerbated when shareholders of for-profit school management companies demand dividends. The scope of monitoring required is huge. Since the passage of the first charter school law in 1991, nearly 2,500 charter schools have opened nationwide, serving nearly 600,000 children.[93] Last year alone, 374 new charter schools opened their doors.[94] About 10% of the country's currently operating 700 or so charter schools are managed by fewer than fifteen for-profit companies.[95]

B. Edison Schools, Inc.

The largest school management corporation is Edison Schools, Inc., a for-profit, publicly-held company that developed its design for Edison schools during 1991-1994. In 1995 Edison opened four elementary schools under contract with their public school administrators.[96] Edison now bills itself as the "country's leading private manager of public schools"[97] with over 100 schools in twenty-two states,[98] and asserts that over 75,000 students nationwide attend Edison partnership schools.[99] Edison, however, has not yet managed to turn a profit.[100] For the fiscal year ended June 30, 2001, Edison reported a net loss of $38.1 million; its accumulated deficit since November 1996 was approximately $153.6 million.[101] The Securities and Exchange Commission lists over 50 filings for

92. For a discussion of the issues of educational malpractice in the special education context, *see* John G. Culhane, *Reinvigorating Educational Malpractice Claims: A Representational Focus*, 67 WASH. L. REV. 349 (1992).

93. Press Release, Center for Educational Reform, CER Releases National Charter School Directory 2001-2002: Nearly 2,500 Schools Open in Just 10 Years (Jan. 7, 2002), *at* http://www.edreform.com/press/2002/ncsd0102.htm (last visited June 12, 2002).

94. *Id.*

95. National Education Association: For-Profit Charter Schools, *Charter Schools Run by For-Profit Companies*, *at* http://www.nea.org/issues/corpmngt/corpchar.html (last visited June 1, 2002).

96. National Education Association, *Corporate Takeovers: The Companies*, The Edison Project, *at* http://www.nea.org/issues/corpmngt/back.html (last visited June 1, 2002).

97. *See* http://www.edisonproject.com/home/home.cfm (last visited Apr. 8, 2002).

98. Susan Snyder and Martha Woodall, *A Study Guide to the Companies that Will Operate Phila. [sic] Schools*, PHILA.INQUIRER, April 18, 2002, at A10.

99. *Id.* Estimates of students in Edison schools vary widely, depending on the source. *See, e.g.*, Center for Education Reform, *Education Entrpreneurs Serving Public Schools at* http://www.edreform.com/education_reform_reources/business_industry.htm (last visited Apr. 7, 2002) (reporting 57,000 students attend Edison Schools).

100. Jacques Steinberg, *For-profit School Venture Has Yet to Turn a Profit*, NY TIMES ON THE WEB, Apr. 8, 2002, *available at* http://www.nytimes.com (last visited June 12, 2002).

101. *See* http://biz.yahoo.com/e/010926/edsn.html (last visited June 12, 2002).

Edison Schools, Inc. between October 26, 1999 and October 26, 2001.[102] Fourteen more occurred between January 16, 2002 and March 11, 2002.[103] While many of them are proxy solicitations, most are repeated offerings to raise capital. Stock analysts peg Edison's predicted five-year growth rate at 30%.[104] For the fiscal year ending June 2001, Edison's sales were $375.8 million, with a one-year sales growth rate of 67.3%. Their 2001 net income was $38.1 million, and their number of employees rose to 4,869, a 28.1% growth increase.[105] Edison investors seemed poised to begin receiving significant returns on their investments before the downturn in Edison's prospects in Philadelphia. Whether the situation in the Philadelphia School District will affect Edison's future profitability remains to be seen.[106]

C. Results of Privatized Management

Advocacy groups for school reform tout the overall success of charter schools,[107] but Edison has not demonstrated improved student achievement.[108] Edison schools report significant gains on a per-school basis, but standard measures of educational success do not support their self-assessments.[109]

Are there appropriate, generally accepted and legally significant indicators or criteria by which to judge the educational performance of for-profit school management corporations and hold them accountable under the law to students and parents who are on the receiving end of their services? Biancalana argues that a paradigm of corporate stakeholder primacy is untenable because of the inability to identify justiciable and effective standards of conduct for corporate directors.[110] The question of choosing a curriculum and providing curricular

---

102. *See* U.S. Securities and Exchange Commission *at* http://www.sec.gov/archives/edgar/data/949014/0000908737-00-000032-index.html (last visited June 1, 2002).

103. *See* U.S. Securities and Exchange Commission *at* http://www.sec.gov/srch-edgar (last visited Apr. 9, 2002).

104. *At* http://www.quotes/hoovers.com/thomson/analyst.html (last updated Nov. 1, 2001). Recent reverses in Edison's fortunes, however, will affect these projections. *See supra*, note 28.

105. Edison Schools, Inc. *at* http://www.hoovers.com/co/capsule/8/0,,55478,00.html (last visited June 1, 2002).

106. *See supra* note 28.

107. Press Release, Center for Education Reform, Achievement Gains Found at California Schools, *at* http://www.edreform.com/press/2002/cacharterstudy.htm (last visited Apr. 7,2002).

108. Commentators report "middling success." *See* Dale Mezzacappa, *Big Change at Districts, Less So in Classrooms*, PHILA. INQUIRER, Nov. 4, 2001, at A1. *See also* Dan Hardy, *Edison Fares Poorly in Review*, PHILA. INQUIRER, Mar. 12, 2002, at B1. *See also* F. Howard Nelson & Nancy Van Meter, *What Does Private Management Offer Public Education?* 11 STAN. L. & POL'Y REV. 271, 276, 281 (2000).

109. *See* Edison Schools, *Fourth Annual Report on School Performance*, September 2001, *at* http://www.edisonproject.com/home/home.cfm. *But see American Federation of Teachers Report—Executive Summary*, *at* http://www.igc.org/trac/feature/education/emo/aft2.html (last visited Nov. 5, 2001), reporting on Robert Mislevy's studies and discrepancies between Edison's measurements of student achievement and the results of standard methods of educational evaluation. *See also* Susan Snyder, *Nationwide, Consultant Averages a "B,"* PHILA. INQUIRER, Mar. 31, 2002, at A1.

110. Biancalana, *supra* note 76, at 431-34, 449.

resource materials for students indicate this concern is valid in the education context. "Yes-no" decisions have measurable outcomes. The effects of decisions relating to the quality and quantity of educational resources are hard to assess.[111] How many computers per school are really needed to improve instruction and student learning? Certainly, computers are needed; but how many? How expensive does the textbook have to be to support educational excellence? The bottom line is that for for-profit school management corporations to realize profits for their shareholders, they must spend less than they receive. Suppose the zeal to turn a profit compromises the education delivered to students? What potential causes of action and what remedies exist?

IV. HOLDING SCHOOL MANAGEMENT COMPANIES ACCOUNTABLE

Tort law, contract law and agency law all may provide mechanisms for holding for-profit school management companies accountable and afford remedies for educational mistakes they make.[112] Constitutional law also may afford causes of action and remedies because public charter schools are state-funded, the school officials act under state authority to provide educational services, and the interests of students are involved. Governmental immunity, however, may apply if the operators of the public charter school are considered state actors. Constitutional claims pose a high bar and likely would be unhelpful in this setting. Other commentators have addressed them and have come to similar conclusions.[113]

A. Accountability in Tort Law

Possible causes of action in tort include claims of negligence and misrepresentation. Courts have generally disfavored negligence suits or educational malpractice claims because of the difficulty of establishing the school's stan-

111. Note, *The Hazards of Making Public Schooling a Private Business*, 112 HARV. L. REV. 695, 699 (1999). "Defining the product or service that a school provides has proven tricky. . . . The unclear boundaries of what constitutes 'education' . . . make contracting in advance difficult." *Id.*

112. Remedies available under the federal securities laws are beyond the scope of this paper. Federal securities laws protect the integrity of information reaching the marketplace; private causes of action may not be available to remedy abuses of the nature for which students or their parents would seek redress.

113. Kemerer & Maloney, *supra* note 10, at 597-601. Kemerer & Maloney focus on accountability measures enacted in three states: Arizona, Michigan and Massachusetts. *Id.* at 610-20. Mead & Green also reject causes of action in constitutional law because cases like San Antonio Sch. Dist. v. Rodriguez, *supra* note 7, negate a constitutional mandate to educate. *See* Mead & Green, *supra* note 89, at 40. *See also* Wall, *supra* note 16, at 77-83.

dard of care[114] or causation,[115] or for public policy reasons.[116] However, heightened measures of assessing schools' educational performance in the form of criteria-referenced or normed state-mandated tests for educational proficiency may establish standards of care sufficient to satisfy courts.[117] Several commentators have argued for modified causes of action for educational malpractice manifesting after students transfer from charter schools back to traditional schools of residence.[118] Misrepresentation claims, especially intentional misrepresentation, however, stand little likelihood of success because of the difficulties of proving either intent to deceive or justified reliance.[119]

B. Accountability Under Contract Law

Since school management corporations operate under contract to school districts or schools, districts or schools may revoke contracts for non-performance.[120] Contract revocation, however, provides no damages to students disadvantaged because they lost critical opportunities for education.[121] On the other hand, private causes of action in contract may provide suitable avenues of litigation for students and their parents. Commentator Kevin McJessy argues that any one of three contract law theories would support claims of educational malpractice against school management companies: implied or express conduct, third-party beneficiary, or promissory estoppel.[122] However, contract theories based on conduct of the parties suffer from difficulties of proving offer and acceptance in the context of mandatory schooling or consideration where no tuition payments exist.[123] Similarly, third party beneficiary claims are not likely to prove successful because of courts' general reluctance to honor such claims against the government, and promissory estoppel claims suffer from the difficulty of proving reliance.[124]

---

114. *See* Peter W. v. San Francisco Sch. Dist., 131 Cal. Rptr. 854, 860 (Cal.Ct. App. 1976).

115. *Id.* at 861.

116. Courts are reluctant to review the day-to-day decision of school administrators. Donohue v. Copiague Union Free Sch. Dist., 391 N.E.2d 1352, 1354 (N.Y. 1979).

117. Mead & Green, *supra* note 89, at 38-40.

118. *See* Conn, *supra* note 64. *See also* Cheryl L. Wade, *Educators Who Drive With No Hands: The Application of Analytical Concepts to Corporate Law in Certain Cases of Educational Malpractice*, 32 SAN DIEGO L. REV. 437 (1995).

119. Mead & Green, *supra* note 89, at 38.

120. Wall, *supra* note 16, at 84, 91-96.

121. *Id.*

122. Kevin P. McJessy, *Contract Law: The Proper Framework for Litigating Educational Liability Claims*, 89 NW U.L. REV. 1768 (1995).

123 Mead & Green, *supra* note 89, at 41-42.

124. *Id.* at 42-43.

C. Accountability in Agency Law

The law of agency essentially implicates the fiduciary duty of loyalty.[125] The duties not to compete with the principal, not to profit from the agency relationship, not to act adversely to the principal, and not to use or disclose the principal's confidential information are basically the duties of a fiduciary who would remain loyal to his beneficiaries;[126] in the case of for-profit corporations, these are the shareholders. Students generally are not shareholders of the school management corporations whose schools they choose to attend. Agency law alone is not likely to prove helpful in holding school managers accountable to students or parents.

D. Causes of Action in Corporate Law

Largely unexplored by commentators to date are causes of action against for-profit school management corporations under state corporate law, namely, for directors' breaches of fiduciary duties. Behavioral law and economics (BLE) scholars argue for basic changes in the traditional view that directors owe fiduciary duties exclusively to shareholders.[127] Supporters of "other constituency" statutes argue for the same changes.[128] Reform of this magnitude in American corporations and perhaps in the industrialized world, however, is likely to be far in the future.[129] A much less radical solution exists.

States and chartering entities should require that school management corporations make students and/or parents voting shareholders in the corporation by bestowing some nominal number of shares in the corporation on students when they enroll.[130] By virtue of shareholder status, students and parents (or guardians) acquire certain substantive rights not available to non-shareholders. Depending on the details of the applicable state corporation law, they may be able to compel boards of directors to hold annual meetings at which directors are elected.[131] Similarly, under certain conditions they may be able to make

125. Paula J. Dalley, *To Whom It May Concern: Fiduciary Duties and Business Associations*, 26 DEL. J. CORP. L. 515, 520 (2001).

126. *Id.*

127. Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS L. REV. 581, 589, 601-11 (2002).

128. *Id.* at 605-07.

129. *See* Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 454 (2001).

130. The school management corporations could limit the percentage of commons stock that would be put aside for parents and/or students, and even require that shares be returned upon exiting the school. *Compare* the Japanese system of "inside/outside" shareholders. *See* Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and their Solutions*, 25 DE. J. CORP. L. 189 (2000). *See also* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

131. *Compare* Delaware General Corporation Law, DGCL § 211.

demand for certain corporate records,[132] including stock lists that would be helpful in locating other students and their parents for potential class actions (especially in the cyber charter school situation, where students do not meet face-to-face), valuation information about corporate assets and shares, and information about corporate mismanagement of which they have knowledge. Perhaps most importantly, students and their parents acquire standing to bring direct, derivative or class action suits against the corporation or its directors for breaches of fiduciary duties.[133]

Delaware corporate statutes and common law demonstrate both optimistic and pessimistic aspects of this approach. As the dominant choice of state incorporation for the largest United States corporations, half of the companies listed on the New York Stock Exchange, and over 60% of all Fortune 500 companies,[134] Delaware's pre-eminence in corporate law is well established. However, substantial variations in state corporate laws exist.[135] Nevertheless, in that Delaware's corporate statute provides minimal guidance about fiduciary duties, it is typical of other state statutes.[136]

The source of definitive pronouncements on the fiduciary duties of directors of for-profit corporations is Delaware's common law.[137] One obvious advantage of this judicial lawmaking scheme is that it is plaintiff driven. Delaware even releases plaintiffs from shouldering the costs of litigation with a range of fee shifting structures that award attorneys' fees to litigants.[138] Plaintiff shareholders who wish to sue the corporation, however, must demonstrate that they have sought relief from the corporation before appealing to the courts.[139]

This demand requirement is the first and often-insurmountable obstacle to bringing shareholder derivative suits in Delaware courts for directors' breaches of fiduciary duty.[140] In response to shareholder demand, the board of directors may form a litigation committee of disinterested and independent directors who can dismiss the suit as not in the best interest of the corporation.[141] If the plaintiff fails to make a demand, the court will dismiss the suit. The decision of

---

132. *Compare* DGCL §220.

133. *See generally* Jill E. Fisch, *Teaching Corporate Governance through Shareholder Litigation*, 34 GA. L. REV. 745 (2000).

134. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1061, 1066-67 (2000).

135. *But see id.* at 1062 (asserting that state corporate laws differ only minimally from each other.).

136. *Id.* at 1074-75.

137. *Id.* at 1089.

138. *Id.* at 1090-91.

139. Harvey Gelb, *Corporate Governance Guidelines: A Delaware Response*, 1 WYO. L. REV. 523, 529 (2001). *See also* E. Norman Veasey & Michael P. Dooley, *The Role of Corporate Litigation in the Twenty-first Century*, 25 DE. J. CORP. L. 131 (1999).

140. Gelb, *supra* note 139, at 529.

141. *Id.* at 529-30.

the litigation committee is subject to the business judgment rule,[142] boding ill for the plaintiff's chances of getting to court.[143] A shareholder plaintiff may plead that the court excuse demand because it would be futile considering the incumbent board of directors, but such pleading must state particularized facts creating a reasonable doubt that the directors were disinterested, independent, or otherwise protected by the business judgment rule.[144] The demand requirement sets a high bar to litigation. However, demand also effectively prescribes a species of alternative dispute resolution that itself may work to a prospective plaintiff's advantage.[145]

If a plaintiff succeeds in a shareholder derivative suit, only the corporation itself may receive reimbursement for the directors' breaches of fiduciary duties. A shareholder can bring a suit on her own behalf, a direct action, only if she alleges a wrong involving a contractual right that exists independently of any right of the corporation.[146] If a director violates his duty of loyalty by wasting corporate assets, e.g., by arranging to keep his fellow directors in the dark about his personal spending of corporate funds, a student may claim that the director infringed her right to have those funds spent on her education, a right that, as a legal but not real person, the corporation cannot claim. How a court would view such a claim is uncertain.

Finally, students who collectively suffer diminishing successes on state-mandated examinations during an extended period of attendance at public charter schools or schools managed under contracts by school management corporations, as contrasted with peers in traditional public schools, may institute a class action suit against the directors of the corporation for breaches of the duties of care and loyalty, as relevant. Again, how courts will view class action suits for collective educational malpractice is uncertain.

E. Rescissory Damages

What kinds of damages might students expect to remedy the educational wrongs perpetrated by directors' breaches of fiduciary duties? Reimbursement and compensatory damages have long been recognized as appropriate remedies in the special education context under the Individuals with Disabilities in

142. The business judgment rule is a presumption that disinterested and independent directors made a corporate decision by employing a reasonable decision-making process, acting in subjective good faith. *See* Allen, Jacobs & Strine, Jr., *supra* note 2, at 1298.

143. *Id.*

144. Gelb, *supra* note 139, at 530-31. *But see* Mark J. Loewenstein, *Delaware As Demon: Twenty-five Years After Professor Cary's Polemic*, 71 U. COLO. L.R. 497, 520 (2000) (where Loewenstein argues that Delaware courts assiduously scrutinize litigation committee decisions to dismiss derivative suits).

145. Gelb, *supra* note 139, at 534.

146. Grimes v. Donald, 673 A.2d 1207, 1213 (Del. 1996).

Education Act (IDEA).[147] Compensatory education would be especially appropriate where a school's charter was revoked so that the school no longer existed.[148]

Corporate law provides a spectrum of both actual and equitable damages particularized for the many different contexts in which valuation issues arise.[149] Some, such as the appraisal remedy available in the merger context,[150] do not pertain to suits potentially initiated by students deprived of educational opportunities. Absent fraud, however, other remedies available for breaches of fiduciary duty are pertinent. Courts may impose equitable remedies or award monetary damages.[151] Damages may be compensatory or rescissory. In some cases, courts may not require proof of injury.[152]

If school management directors breach their fiduciary duties to students who are shareholders, and students successfully sue in either a derivative, direct or class action suit, rescissory damages may be the most suitable form of damage remedy. An equitable remedy, rescissory damages are most appropriate when fiduciaries unjustly enrich themselves by exercising their authority deliberately to extract personal financial gain at the expense of those who depend on them.[153] In the complicated scheme of mergers and other corporate exchanges, rescissory damages must be claimed in a timely fashion or forfeit.[154] However, in the public school environment, proceedings move more slowly than in the fast-paced corporate world. Nevertheless, recission itself would be an impossible remedy because deprivation of educational opportunity is irreversible, but rescissory damages could pay for compensatory education or tutoring.

Delaware courts are reluctant to award rescissory damages.[155] They are available only for situations where directors have breached their duty of loyalty, not for breaches of duty of care alone.[156] If directors of school management corporations pay themselves high salaries or otherwise exploit funds that rightly should have purchased educational materials or services while students lack

147. *See* Mead & Green, *supra* note 89, at 61, n.121, *citing* Burlington School Committee v. Dept. of Educ., 471 U.S. 359 (1985); Florence County School District Four v. Carter, 510 U.S. 7 (1993); Jefferson County Board of Education v. Green, 853 F.2d 853 (11th Cir. 1988); Lester H. v. Gilhool, 912 F.2d 865 (3d Cir. 1990).

148. Mead & Green, *supra* note 89, at 63.

149. *See generally* Jay W. Eisenhofer & John L. Reed, *Valuation Litigation*, 22 DE. J. CORP. L. 37 (1997).

150. *Id.* at 39-42.

151. *Id.* at 55-79.

152. *Id.* at 74.

153. *Id.* at 75.

154. *See* Strassburger v. Earley, 752 A.2d 557 (Del. Ch. 2000); Bomarko, Inc. v. International Telecharge, Inc., 1999 WL 33472141 (Del. Ch. Nov. 4, 1999, *revised* Nov.16, 1999), *aff'd* International Telecharge, Inc. v. Bomarko, Inc., 766 A.2d 437 (Del. 2000).

155. Strassburger v. Earley, 752 A.2d at 579 (Del. Ch. 2000).

156. *Id.* at 578. *See also* Cinerama v. Technicolor, Inc., 663 A.2d 1134 (Del. Ch. 1994), *aff'd* 663 A.2d 1156 (Del. Sup. 1995).

basic educational supplies, this could constitute a breach of the duty of loyalty. Similarly, if directors seek to entrench themselves in control, for whatever personal reasons, this is a breach of the duty of loyalty. Care may also be involved in the breach, but the requisite showing of a breach of loyalty is satisfied.

A classic decision in which the Delaware Court of Chancery considered plaintiff's request for a monetary award based upon the theory of rescissory damages was *Weinberger v. UOP*.[157] The Delaware Supreme Court remanded *Weinberger* to Chancery so the court could enlarge the class of minority shareholders the plaintiff represented and consider all relevant factors of valuation. Chancellor Brown ultimately declined to award rescissory damages to shareholders allegedly disadvantaged by a merger that had occurred years ago, awarding $1 per share nominal damages instead. The Chancellor explained his understanding of rescissory damages as designed to reward the shareholder with the highest valuation the stocks had attained between the time of the wrongdoing and the time of the lawsuit, minus the price they had already received at sale. In effect, rescissory damages would have allowed the shareholders "to be made nearly as whole as possible."[158] Although Chancellor Brown did not deem such damages appropriate in *Weinberger* because of the speculative nature of the damage amounts claimed, the goal of making educationally deprived students "nearly as whole as possible" seems appropriate. Damages could be calculated based on the costs of compensatory education or of tutoring to reach competency in areas in which students tested as deficient.

In *Strassburger v. Earley*,[159] Vice Chancellor Jacobs tackled the issues involved in awarding rescissory damages. Jacobs appeared to be troubled because rescissory damages could include post-transactional incremental valuation elements.[160] While acknowledging that a complete rescission of the transaction, were it possible, would have most effectively undone the harm inflicted,[161] Jacobs ruled in *Strassburger* the alleged wrongdoer was not a party to the lawsuit, and that, moreover, his culpability had not been established. Although the court failed to award rescissory damages, Jacobs' assessment of when they would be proper, i.e., when rescission of the transaction would be the most appropriate remedy if possible, is entirely applicable in the case of students who receive inadequate educational services because the directors of a for-profit corporation have been disloyal to their shareholders by misusing corporate funds out of self-interest. That rescissory damages might be devastating to the defendants, a concern that troubled V.C. Jacobs,[162] is a concern relevant in

157 1985 WL 11546 (Del. Ch. Jan. 30, 1985).
158. *Id.* at *3.
159 752 A.2d 557 (Del. Ch. 2000).
160. *Id.* at 578.
161. *Id.*
162. *Id.* at 580.

the educational context as well. If award of rescissory damages for one student or group of students puts a corporation-managed school out of business, all students enrolled in the school thereby suffer disruption of their educational process. Similarly, the negative ripples will extend to the public schools that must accommodate the displaced students. Safeguards would have to be put in place.

In another well-known Delaware decision concerning rescissory damages, *Cinerama v. Technicolor, Inc.*,[163] Chancellor Allen identified yet another rationale that makes rescissory damages especially appropriate in the student context: principles of restitution. This is the same rationale identified in *Lynch v. Vickers Energy Corp.*[164] The need for restitution is an important assignment of blame that society should hear when directors of for-profit school management corporations betray the public trust.

The benefits that could potentially accrue to students and/or their parents as shareholders of school management corporations entrusted either directly or indirectly with the students' education would outweigh inconveniences and costs the corporations might allege. No other remedy besides rescissory damages comes close to making the students whole. Moreover, the ability to have a voice in the corporation that holds the purse for students' educational resources, even if only to demand meetings or production of records when statutory conditions are fulfilled, is a strong policy argument in favor of making students and parents shareholders.

F. The Standing Problem in the Nonprofit Context

Shareholder standing to sue the directors of a for-profit corporation for breaches of fiduciary duty is widely acknowledged. Although, as noted above, most nonprofit school management corporations are smaller, more mission-oriented business organizations, directorial abuses may still occur in nonprofits. The difficulty of establishing standing to sue a nonprofit corporation may be an effective deterrent to suits against genuine nonprofit school management companies.[165] However, their for-profit subcontractors will not be immune to suit; neither will for-profit school management corporations like Edison Schools, Inc., if any of the causes of action discussed above receive favorable attention in the courts. Similarly, statutes of limitation may also bar suits for one or more of the remedies discussed. However, courts are likely to toll statutes of limitations that involve minor students just as they toll them for minors in medical malpractice cases.

163. 663 A.2d 1134 (Del. Ch. 1994), *aff'd* 663 A.2d 1156 (Del. 1995).
164. 429 A.2d 497, 501, 505 (Del. 1981).
165. *See* Brody, *supra* note 44, at 1430-31.

V. FUTURE DIRECTIONS IN "PRIVATIZED PUBLIC EDUCATION"

Will school management companies bring about the educational reform they promise? Educators are notorious for their lack of foresight. School districts have a difficult time projecting student enrollments five years in the future, even with the help of local realtors and planning commissions.

At the present time, the only response a public school or school district has dared to make to a non-performing school management corporation is to cancel its contract or close its charter school. Besides leaving students in the lurch, and potentially resulting in unplanned overcrowding in the public school districts forced to accept the displaced students, simply canceling a contract is insufficient to recover the educational losses experienced by the students. While the potential for abuse exists throughout education, public or privatized, the for-profit corporation's imperative to turn a profit for shareholders legitimizes corporate cost cutting. The line between corporate efficiency and inadequate educational spending can be difficult to discern.

Education is an important function and responsibility of the government of a civilized society, even American society where parents' rights in children's education are respected and honored. States, school districts, and parents must find effective remedies at law to support their demands for educational accountability from all who undertake the education of children, but especially from those who would profit at the expense of children. Requiring for-profit corporations to extend shareholder status to students of their schools would open a new avenue of redress for students and their parents. It seems a simple price for corporations to pay for the privilege of educating children.