Office of the Inspector General

Commonwealth of Massachusetts

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Inspector General

Management Update on Two Charter Schools

February 2003

Publication No. 18320-37-50-02/03-IGO, approved by Philmore Anderson III, State Purchasing Agent.
Printed on recycled paper.

Management Update on Two Charter Schools

Introduction

In November 1999, the Office of the Inspector General issued a report entitled *A Management Review of Commonwealth Charter Schools,* which examined 24 Commonwealth charter schools and identified weaknesses in the contracting practices, procurement procedures, and financial management of some charter schools.[1] The Office then undertook a follow-up review of the business operations of certain charter schools identified in the report as potential sources of risk.

In November 2000, the Office issued a report entitled *SABIS International Charter School: Management Issues and Recommendations.* In January 2001, the Office issued a report entitled *Somerville Charter School: Management Issues and Recommendations.* In each case, the Office found that the charter school's board of trustees had not provided effective oversight of the charter school's finances and business operations. Instead, each board had ceded excessive financial control to its private management contractor. In doing so, each board had diminished its own capacity to control the public funds provided to the charter school and to oversee the management contractor's performance in administering those funds.

This report provides updated information on changes to each school's business operations and contractual relationship with its management contractor instituted in response to the Office's findings and recommendations. The first section of this report concerns the SABIS International Charter School, and the second concerns the Somerville Charter School.

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[1] The Massachusetts charter school law, M.G.L. c. 71, §89, authorizes the Massachusetts Board of Education to grant charters to charter schools, which are public schools managed by public boards of trustees. A Commonwealth charter school is a public school that operates independently of any school committee under a five-year charter granted by the Board of Education.

SABIS International Charter School

Background

The Board of Education first awarded a five-year charter to the SABIS International Charter School in Springfield ("the School") in March 1995 and renewed the School's charter in July 1999. In August 1995, the School's Board of Trustees executed a five-year contract with a private, for-profit company, the Minnesota-based firm of SABIS Educational Systems, Inc. ("SABIS Inc.") for comprehensive educational and administrative management services.[2] In March 2000, the Board executed a new five-year contract with "Springfield Education Management LLC, a Delaware Limited Liability Company," a limited liability corporation created by SABIS Educational Systems, Inc.[3] The Board of Education approved a revised version of this contract on March 27, 2001.[4]

The Office's November 1999 report on 24 charter schools found that the SABIS International Charter School's 1995 management contract with SABIS Inc. contained no performance requirements measuring students' academic achievement and did not accurately reflect the School's actual compensation arrangement with SABIS Inc. The 1999 report also found that the School's substantial financial obligations to SABIS Inc. could render the School excessively dependent on SABIS Inc., that the School exhibited warning signs of financial problems, and that the School had reportedly failed to take timely actions to correct internal control deficiencies identified by its independent auditors.

The major findings of the Office's subsequent report on the School, *SABIS International Charter School: Management Issues and Recommendations*, issued in November 2000, were as follows:

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[2] The 1995 contract was executed with the International School of Minnesota, Inc., which transacted business in the Commonwealth as SABIS Educational Systems, Inc.

[3] In the interests of clarity and simplicity, this report will continue to refer to this limited liability corporation as "SABIS Inc."

[4] Under the charter school law, the Board of Education is required to approve the terms of any charter school contract with a private entity that will provide "substantially all educational services" to the school." [M.G.L. c. 71, §89(j)(5)]

- The Board of Trustees had not employed sound business and contract oversight practices in administering the financial relationship of the School with SABIS Inc. during the first five years of School operations.

- The contract with SABIS Inc. executed by the Board of Trustees in March 2000 would significantly increase the School's exposure to fraud, waste, and abuse.[5]

- The Board of Trustees had not accurately documented its official actions and policies.

The Office's report offered a series of recommendations designed to strengthen the Board's capacity to oversee and control the School's business operations, including its contract with SABIS Inc. The Board's response to the report acknowledged the need for improved governance, although the Board expressed disagreement with some report findings and recommendations.

On December 18, 2000, the Office provided comments to the Department of Education ("DOE") regarding a revised version of the Board's contract with SABIS Inc. (The Office's letter to the DOE, discussed in greater detail below, is provided in Appendix A.) In April 2002, the Office sent a letter to the Board requesting a summary of the Board's actions in response to the Office's November 2000 report on the School and the outcomes of those actions. On April 18, 2002, an attorney representing the Board sent a letter to the Office summarizing actions taken by the Board in response to the Office's 1999 report as well as the Office's 2000 report. (The letter from the Board's attorney is provided in Appendix A without the accompanying attachments.)

[5] The Office's 2000 report noted that the March 2000 version of the contract did include a number of positive changes in response to the findings of the Office's 1999 report. Unlike the School's 1995 contract with SABIS Inc., the March 2000 version required SABIS Inc. to meet or exceed specific educational outcomes reflecting students' academic achievement. Unlike the 1995 contract, the March 2000 version contained an explicit compensation provision guaranteeing SABIS Inc. a license fee and a management fee and permitting reimbursement to SABIS Inc. for "corporate expenses" only with advance written approval of the Board.

Management Contract Issues

The Board had executed a new contract with SABIS Inc. in March 2000 and submitted the new contract to the DOE in April 2000 for review and approval by the Board of Education, as required by the charter school law. However, the Board of Education had not approved the contract as of November 2000, when the Office issued the report raising concerns regarding the terms of the contract executed by the Board of Trustees in March 2000.

In November 2000, shortly after the release of the Office's report, the DOE provided the Office with a revised version of the Board's contract with SABIS Inc. and advised the Office that the DOE intended to recommend that the Board of Education approve the revised contract.

In December 2000, the Office wrote a letter to the DOE providing the Office's comments on the November 2000 version of the Board's contract with SABIS Inc. Noting that some improvements had been made in response to the Office's recommendations regarding the March 2000 version of the contract, the Office advised the DOE that the new version of the contract did not address several major concerns outlined in the Office's November 2000 report and, in some areas, further increased the risks to the School. The Office urged the DOE to advise the Board of Trustees to redraft the contract to reduce the unnecessary risks posed by some provisions. The Office also strongly recommended that the DOE reconsider its decision to recommend that the Board of Education approve the contract. (The Office's December 18, 2000 letter to the DOE is provided in Appendix A.)

On March 27, 2001, the Board of Education approved an amended contract between the School's Board and SABIS Inc. The final contract had been amended to address several concerns raised in the Office's December 18, 2000 letter to DOE; however, several provisions to which the Office had objected were unchanged in the final contract.

Scope of SABIS Inc.'s services. The Office's November 2000 report found that although SABIS Inc. had charged the School more than $950,000 in management fees between 1995 and 1999, the salaries of the on-site staff who administered the School's business operations on a daily basis during this period had been paid by the School rather than by SABIS Inc. The report recommended that any new management contract executed by the Board specify the services the contractor was required to provide as a condition of payment of the contractually authorized fees, specify the dollar amounts of the fees, and specify contract staffing requirements for all on-site staff provided and funded by the contractor.

However, neither the March 2000 version nor the November 2000 version of the contract with SABIS Inc. specified the services to be provided by SABIS Inc. for the management fee, nor did either version require SABIS Inc. to provide or pay staff to manage the School. The Office's December 18, 2000 letter to the DOE stated:

> In essence, the revised [November 2000] contract requires the School to pay [SABIS Inc.] six percent of the School's public tuition revenues – at least half a million dollars in annual fees – but does not require [SABIS Inc.] to provide specific services or staff in return. The School should not be permitted to dispense education funds to [SABIS Inc.] under this fundamentally flawed and vulnerable arrangement.

The final contract with SABIS Inc. approved by the Board of Education in March 2001 contained new language clarifying that SABIS Inc.'s management fee would cover only costs related to SABIS Inc.'s off-site employees:

> **The management fee shall cover [SABIS Inc.'s] employee salaries and costs related to off-site employees**, but shall not be applied toward on-site employee salaries, costs or expenses, including the director and other administrative positions. All on-site employment related expenses (i.e. director, administrative positions, teachers, etc.) shall be paid from the annual budget approved by the Board of Trustees as set forth herein. [Emphasis added.]

However, the final contract did not specify the services to be provided to the School by SABIS Inc.'s off-site employees.

SABIS Inc.'s expense reimbursements. The Office's November 2000 report found that the Board had authorized more than $300,000 in reimbursements to SABIS Inc. for "corporate support" expenses that were not authorized by the 1995 contract or substantiated with invoices. The report recommended that any new management contract specify allowable reimbursements, if any, and require the contractor to submit invoices and written justification for all expenses submitted for reimbursement.

In response to these concerns and recommendations, the March and November 2000 versions of the School's contract with SABIS Inc. contained a provision authorizing SABIS Inc. to be reimbursed for expenses only with advance written approval of the Board. The November 2000 contract version also stated that the Board would approve for reimbursement only those expenses determined to be "beyond the scope of the management services for which [SABIS Inc.] is being compensated by the management fee." However, neither version specified the allowable reimbursements or required SABIS Inc. to submit invoices substantiating its reimbursement requests.

The Office's December 18, 2000 letter to the DOE noted that because the November 2000 version did not specify the services to be provided by SABIS Inc. in return for the management fee, the contract provision governing reimbursement of expenses had little meaning and could not be enforced. In response, the final contract approved by the Board of Education included a provision requiring SABIS Inc. to submit "appropriate documentation (i.e. invoices)" to the Board of Trustees in order to be entitled to reimbursement for contract-related expenses. In the April 18, 2002 response to the Office, the Board's attorney stated: "The [Board's] Finance Committee now reviews on a monthly basis all income and expenses of the School."

Thus, the final contract with SABIS Inc. approved by the Board of Education contained additional safeguards over the School's expense reimbursements to SABIS Inc. However, its lack of specificity regarding the scope of the services covered by SABIS Inc.'s management fee rendered the Board vulnerable to requests for reimbursement of expenses for items or services that should be covered by SABIS Inc.'s management fee.

SABIS Inc.'s financial control over the School. The Office's November 2000 report found that the March 2000 version of the contract with SABIS Inc. would significantly increase SABIS Inc.'s financial control over the School while reducing Board oversight by requiring the Board to transfer all School funds, except those funds budgeted for Board operations, to SABIS Inc. The contract would therefore give SABIS Inc. responsibility for managing all School funds except those funds budgeted for Board operations. The report stated that SABIS Inc. had consistently failed to institute sound business systems and practices over a four-year period despite repeated findings by the School's auditors of major internal control weaknesses in the School's Business operations. Thus, the report argued that increasing SABIS Inc.'s control over School finances would be extremely risky and unwise as well as inappropriate. The report recommended that the Board draft a new contract that would ensure appropriate restrictions on the management contractor's access to School funds.

The November 2000 version of the contract included a provision stating that all funds received on behalf of the School would initially be deposited in a Board account and that funds budgeted for the operation of the School would be deposited in a School operating account on a quarterly basis. Expenditures from the School operating account would be made only in accordance with the budget and upon approval in writing by the School Director or the Business Manager to whom the Director might delegate this responsibility.

It was unclear whether or not this provision would reduce SABIS Inc.'s control over School funds. The contract also provided that SABIS Inc. would hire all

School personnel, including the Director and the Business Manager. The contract also stated that the Director would report to both the Board and to SABIS Inc. The Office's December 18, 2000 letter to the DOE noted:

> This confusing organizational structure could create conflicts of interest for the Director and the Business Manager, neither of whom could effectively serve the interests of both parties to the contract.

The provision stating that expenditures from the School's operating account would be made upon approval in writing by the Director or the Business Manager did not appear in the final contract approved by the Board of Education. Thus, the final contract did not specify who would control this account, nor did it restrict SABIS Inc.'s access to this account.

SABIS Inc.'s control over the School's budget. Under the charter school law, the Board of Trustees is responsible for supervision and control of the School and for development of the School's annual budget.[6] The budget is an essential public policy tool that serves as a guide for School expenditures and ensures that School funds are spent in accordance with the board's decisions and priorities. As the public body responsible for governing the school, the Board is thus obligated under the charter school law to approve a budget that reflects its decisions and priorities each year.

The Office's December 18, 2000 letter to the DOE expressed concern regarding the provision in the November 2000 version of the contract requiring the Board to reach agreement with SABIS Inc. on the School's budget each year and stating that any "open issues" on which agreement had not been reached would be submitted to binding arbitration, a requirement that appeared to conflict with the charter school law. The Office's letter to the DOE stated:

> The interests of a public school may differ from those of a private, for-profit company providing services under contract to the school.

[6] M.G.L. c. 71, §89(x).

> The Board – and only the Board – should have the final authority to determine the School's budget. No other party should be permitted to overrule the deeply held convictions of the public body charged by law with the responsibility to govern the School.

The final contract approved by the Board of Education stated that budget disagreements between the Board and SABIS Inc. would be subject to mediation rather than binding arbitration.

Surplus School revenues paid to SABIS Inc. The Office's November 2000 report found that the March 2000 version of the School's contract with SABIS Inc. would significantly increase SABIS Inc.'s potential compensation without changing the functions for which SABIS Inc. had been responsible: in addition to paying SABIS Inc. a license fee, a management fee, and corporate expense reimbursements, the School would be required to pay SABIS Inc. all surplus School funds at the end of every fiscal year. The Office's report noted that a compensation provision that bases a management contractor's payment on the charter school's surplus revenues at the end of the fiscal year creates a disincentive for the management contractor to make or recommend certain expenditures that may be warranted, since any expenditure reduces the school's potential surplus and, thus, the contractor's compensation. In addition, this type of compensation provision eliminates the opportunity for a school to reinvest surplus funds in school operations and to share in the financial benefits of any efficiency measures or cost-saving strategies during the fiscal year. The Office recommended that the Board of Education disapprove any contract with SABIS Inc. containing this provision.

The Office's December 18, 2000 letter to the DOE reiterated the Office's objection to this contract provision. The Office also expressed concern regarding a contract provision prohibiting the Board of Trustees from withholding approval of SABIS Inc.'s proposed budget "for the sole purpose of diminishing year-end operating balances." Although this provision suggested that the year-end operating balance to be paid to SABIS Inc. would be included in the School's budget, along with the management fee, license fee, and reimbursements paid to SABIS Inc., the November 2000 version of the contract did not specify or set an upper limit on the year-end operating balance that would be included in the School's budget. The Office's letter stated:

> This open-ended arrangement impedes the Board's ability to allocate public education funds in service of the School's educational mission and poses substantial financial risks to the School.

These provisions were unchanged in the final contract approved by the Board of Education.

Negotiated contract extensions. The Office's November 2000 report criticized a provision of the March 2000 version of the School's contract with SABIS Inc. providing for an indefinite contract term (subject only to the renewal of the School's charter and the provisions of the charter school law, School policies developed in conjunction with SABIS Inc., and all other applicable federal and state laws and regulations). The Office's report noted that contracting with SABIS Inc. to furnish services for an indefinite term would insulate SABIS Inc. from competition in the future, thereby reducing its incentives to provide efficient, high-quality services to the School. The report recommended that any new management contract executed by the Board specify a contract term of no longer than five years. The report also recommended that any new contract require the Board to conduct and document a comprehensive evaluation of the contractor's performance prior to any renewal or extension of the contract.

The November 2000 version of the School's contract with SABIS Inc. limited the contract length to three consecutive five-year terms and gave both parties the option to extend the contract beyond the initial five-year term. However, the November 2000 version also included a provision permitting both parties to renegotiate any and all terms and provisions of the contract in exercising the extension options.

Thus, the November 2000 version permitted the noncompetitive negotiation of a new contract with the exercise of each option to extend. The Office's December 18, 2000 letter to DOE noted:

> Giving a contractor the option to extend a public contract -- and foregoing the benefits of market-driven competition for 15 years -- is an unsound contracting approach. If the Board were to exercise sound business practices in future contracts, the Board would establish the major terms and conditions of the contract prior to soliciting competitive proposals from qualified education management companies.

The Office also noted that the November 2000 version of the contract stated that "open issues" resulting from the noncompetitive contract negotiations between the Board of Trustees and SABIS Inc. would be referred to binding arbitration, thereby allowing for the possibility that a third party could set the terms and conditions of this public contract. The provisions discussed above were unchanged in the final contract approved by the Board of Education.

Dispute resolution and termination provisions. The Office's November 2000 report criticized a provision in the March 2000 version of the School's contract with SABIS Inc. that would allow SABIS Inc., but not the School, to terminate the contract after five years. The report also objected to a separate provision that would allow the Board to terminate the contract only if an arbitrator determined that SABIS Inc. either could not or would not remedy a material breach either of the contract or of law. The report argued that both provisions could undermine the School's capacity to hold SABIS Inc. accountable for fulfilling the contract's educational performance requirements. These provisions were omitted from the final contract approved by the Board of Education.

Sound business practices. The Office recommended to the DOE that the November 2000 version of the contract be amended to include provisions requiring SABIS Inc. to adhere to sound business practices such as implementation of internal controls, written accounting procedures, competitive procurement procedures, and record-keeping systems. The final contract approved by the Board of Education did not include such provisions.

Selection and Engagement of the School's Independent Auditor

The Office's November 2000 report found that the Board had inappropriately ceded responsibility to SABIS Inc. for selecting and engaging the services of the School's independent auditor.[7] Board minutes showed that SABIS Inc. had selected and engaged the services of a Minnesota audit firm for the School's 1998 fiscal year audit.[8] The November 2000 report stated that the arrangement raised serious concerns about the independence of the School's audits and recommended that the Board directly select, contract with, and oversee the School's independent auditor.

In April 2002, the Board's attorney advised the Office that the Board had initiated the practice of selecting, engaging, and paying the School's independent auditor. The Board's attorney provided the Office with minutes of a May 23, 2001 Board meeting showing that the Board had voted unanimously to appoint a certified public accounting firm to perform the School's annual independent audit.

Financial Condition of the School

The Office's 1999 report found that the School had exhibited warning signs of financial problems that, if uncorrected, could jeopardize its future viability. The report noted that between June 30, 1997 and June 30, 1998, the School's current ratio – i.e., the ration of current assets to current liabilities – dropped from 1.32 to .74, according to the School's audited financial statements. The 1998 audited financial statements showed that the School's outstanding financial obligations to SABIS Inc. had increased from $375,650 at the end of the 1997 fiscal year to $967,095 at the end of the 1998 fiscal year. The School had deferred payment of hundreds of thousands of dollars in fees and interest

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[7] The charter school law requires each charter school to obtain an annual, independent audit of its accounts and file the audit each year with the DOE and the State Auditor. [M.G.L. c. 71, §89(hh)]

[8] SABIS Inc. had selected this audit firm to conduct audits of all schools operated by SABIS Inc. in the United States.

charges owed to SABIS Inc. in each year. In addition, the School's expenditures exceeded its revenues by $361,436 in the 1998 fiscal year, according to the audited financial statements for that year.

In April 2002, the Board's attorney forwarded a letter dated April 24, 2002 from the School's independent auditor to the Board, stating:

> The [Office's 1999] report identified warning signs that occurred between fiscal year end 1997 and 1998. These included a decrease in the current ratio, an increase in the amount the School owed [SABIS Inc.] and an excess of expenditures over revenues in 1998. Since that time Moriarty & Primack, P.C. has audited the School each year (June 30, 1999 through June 30, 2001). The School's current ratio has steadily increased. At the end of fiscal 2001 it was 1.3. Revenues have exceeded expenditures increasing the net assets of the School to approximately $760,000 at June 30, 2001. The School continues to have a balance due to [SABIS Inc.] each June 30th. This is due to the fact that [SABIS Inc.] advances funds on a short-term basis for operating expenses as the School's cash flow diminishes just prior to tuition payments by the State. When the tuition payments are received the School repays [SABIS Inc.] in full. Beginning in fiscal year 1999, the School has repaid these advances within 30 days after the end of the fiscal year.

Internal Controls

The Office's 1999 report found that the School's auditor had identified internal control deficiencies that could adversely affect the efficiency and integrity of the School's business operations[9] and that the School had reportedly failed to take prompt action to strengthen its operating procedures in response to the auditor's findings.

The previously cited letter from the School's independent auditor to the Board dated April 24, 2002 stated:

> Areas of concern in the past have included: documentation of the financial transactions between the School and [SABIS Inc.], timely reconciliations of account balances and an inventory of the School's fixed assets. We are

[9] The term "internal controls," sometimes referred to as "management controls," refer to the policies, procedures, and organizational arrangements that organizations use to plan, budget, manage, and evaluate their operations.

pleased to report that during the 2001 audit we noted that only the inventory of fixed assets remained an outstanding issue. The School's management has represented that this will be completed prior to June 2002.

Documentation of Official Board Actions and Policies

The Office's November 2000 report found that the Board had not accurately documented its official actions and policies. The minutes of 27 meetings held by the Board between June 1995 and November 1999 contained no documentation of any discussion or recorded votes on the annual school budget, deferred fees and charges owed to SABIS Inc., corporate support expense reimbursements to SABIS Inc., or loans from SABIS Inc. The report also found that the Board had not documented its decision to amend its official student enrollment policy in order to accord preference to children of Board members. Noting that the Board had recently adopted a new open meeting law policy, the Office's report recommended that the Board accurately document all other major policies and, if required, submit them to the Board of Education for approval.

In April 2002, the Board's attorney advised the Office that the Board had hired an independent company to tape and transcribe meeting minutes and that the Board no longer provided preferential treatment to children of Board members.

Somerville Charter School

Background

The Board of Education first awarded a five-year charter to the Somerville Charter School ("the School") in March 1996 and renewed the School's charter in February 2001. In October 1996, the School executed a five-year contract with SABIS Educational Systems, Inc. ("SABIS Inc.") for comprehensive educational and administrative management services.

The Office's November 1999 report on 24 charter schools found that the Somerville Charter School's management contract with SABIS Inc. contained no performance requirements measuring students' academic achievement, included a surplus revenue compensation provision that posed unwarranted risks to the School and the taxpayers, and did not accurately reflect the School's actual compensation arrangement with SABIS Inc. The 1999 report also found that the School's substantial financial obligations to SABIS Inc. could render the School excessively dependent on SABIS Inc., that the School exhibited warning signs of financial problems, and that the School had reportedly failed to take timely actions to correct internal control deficiencies identified by its independent auditors.

The major findings of the Office's subsequent report on the School, *Somerville Charter School: Management Issues and Recommendations*, issued in January 2001, were as follows:

- The Board of Trustees had given SABIS Inc. excessive control over the School's operating funds.
- The School's management organization had impeded Board oversight of the SABIS Inc. contract and full Board access to essential School documents and information.
- The Board of Trustees had inappropriately ceded responsibility to SABIS Inc. for selecting and engaging the services of the School's auditor.

- The surplus provision contained in the School's 1996 contract with SABIS Inc. was disadvantageous to the School.
- The Board's Finance Committee Chair and the Director of the School appeared to hold conflicting views of loan agreements between the School and SABIS Inc.
- Although the Board maintained detailed minutes of its regular meetings, it did not maintain records of its executive sessions.

The report offered a series of recommendations designed to strengthen the Board's capacity to oversee and control the School's business operations, including its contract with SABIS Inc. In response to the report, the Board stated that it planned to use the Office's report as a resource in strengthening the School's financial and management structure.

In April 2002, the Office sent a letter to the Board of Trustees requesting a summary of the Board's actions in response to the Office's January 2001 report on the School and the outcomes of those actions. On behalf of the Board, a Board Trustee sent a detailed response received by the Office in April 2002. (The letter from the Board Trustee is provided in Appendix A.)

Management Contract Issues

The Office's January 2001 report findings highlighted risks posed to the School and its stakeholders by the School's management contract with SABIS Inc. The report focused on four contract-related issues: SABIS Inc.'s control over School funds, SABIS Inc.'s control over the School budget, the School's management organization, and the surplus revenue compensation provision contained in the contract. The Office's specific concerns and recommendations pertaining to these issues are discussed in more detail below.

> **SABIS Inc.'s control over School funds.** The Office's January 2001 report found that the Board had allowed SABIS Inc. to deposit School funds in an operating account under SABIS Inc.'s exclusive control. Without access to or control over the School's operating account, the Board lacked the capacity to

control and safeguard School funds in accordance with its statutory and fiduciary responsibilities. The Office's report recommended that if the Board elected to continue to contract for management of the School's business operations, the Board should ensure that the new contract enabled the Board to exercise appropriate oversight and control over School resources and operations.

SABIS Inc.'s control over the School budget. Under the charter school law, the Board of Trustees is responsible for supervision and control of the School and for development of the School's annual budget.[10] The budget is an essential public policy tool that serves as a guide for School expenditures and ensures that School funds are spent in accordance with the board's decisions and priorities. As the public body responsible for governing the school, the Board is thus obligated under the charter school law to approve a budget that reflects its decisions and priorities each year.

The Office's January 2001 report criticized a provision of the School's 1996 contract with SABIS Inc. requiring the School and SABIS Inc. to agree on the School's annual and projected budgets prior to the start of each school year. By allowing SABIS Inc. to have excessive budgetary control, the Board had undermined its own capacity to protect the financial interests of the School. The Office's report recommended that the Board oversee the preparation and execution of the School's annual budget.

The School's management organization. The Office's report found that the School's management organization had impeded Board oversight of the contract with SABIS Inc. and full Board access to essential School documents and information. Although all School staff were public employees paid from a Board-controlled account, they reported to and were supervised by SABIS Inc. Under this organizational arrangement, the Board could not effectively monitor and oversee SABIS Inc.'s performance under the contract. The report recommended

[10] M.G.L. c. 71, §89(x).

that the Board consider managing the School's business operations with its own staff when the School's 1996 contract with SABIS Inc. expired in 2001.

Surplus School revenues paid to SABIS Inc. The School's 1996 contract with SABIS Inc. provided that SABIS Inc. was entitled to retain any surplus revenues remaining after all School expenses had been paid each year. A compensation provision that bases a management contractor's payment on the charter school's surplus revenues at the end of the fiscal year creates a disincentive for the management contractor to make or recommend certain expenditures that may be warranted, since any expenditure reduces the school's potential surplus and, thus, the contractor's compensation. In addition, this type of compensation provision eliminates the opportunity for a school to reinvest surplus funds in school operations and to share in the financial benefits of any efficiency measures or cost-saving strategies implemented during the fiscal year. The Office's January 2001 report recommended that if the Board elected to continue to contract for management of the School's business operations, the Board should discontinue the practice of allowing the management contractor to retain all surplus School revenues.

In April 2002, the Board Trustee advised the Office that the Board had studied the option of separating the business and educational management functions of the School's operations in the spring of 2001 and had proposed to SABIS Inc. that these functions be separated. According to the Board Trustee, however, the Board's subsequent contract negotiations with SABIS Inc. were unsuccessful. Thus, in November 2001, the Board voted not to pursue contract negotiations with SABIS Inc. and, instead, to take over complete business and educational management of the School as of December 1, 2001. In November 2001, the Board also hired an interim Director of Business and Finance, according to the Board Trustee. In light of the Board's decision to manage the School directly rather than contracting with a private firm for School management, the contract-related findings and recommendations contained in the Office's January 2001 report were no longer applicable as of late 2001.

Selection and Engagement of the School's Independent Auditor.

The Office's 2001 report found that the Board of Trustees had inappropriately ceded responsibility to SABIS Inc. for selecting and engaging the services of the School's independent auditor.[11] The report stated that the arrangement raised serious concerns about the independence of the School's audits and recommended that the Board directly select, contract with, and oversee the School's independent auditor.

In April 2002, the Board Trustee advised the Office that in September 2001, the Board had hired an independent certified public accounting firm to perform the annual audit and to advise the Board on financial issues.

Executive Session Minutes

The Office's 2001 report found that although the Board maintained detailed minutes of its regular meetings, it did not maintain minutes of its executive sessions. Under the open meeting law, boards of trustees are required to maintain minutes that set forth the date, time, place, members present or absent, and actions taken of each meeting, including executive sessions.[12] The report recommended that the Board of Trustees seek guidance regarding its fiduciary duty and establish procedures to comply with the requirements of the open meeting law.

In April 2002, the Board Trustee advised the Office that the Board had adopted written procedures on compliance with the open meeting law, particularly with respect to executive sessions.

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[11] The charter school law requires each charter school to obtain an annual, independent audit of its accounts and file the audit each year with the DOE and the State Auditor. [MG.L. c. 71, §89hh]

[12] M.G.L. c. 30A, §11A½.

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Appendix A: Charter School Correspondence

1. Letter from the Office of the Inspector General to the Department of Education, December 18, 2000.

2. Letter (without attachments) from an attorney representing the SABIS International Charter School Board of Trustees to the Office of Acting Inspector General Gregory W. Sullivan, April 18, 2002.

3. Letter from a Trustee representing the Somerville Charter School Board of Trustees to the Office of Acting Inspector General Gregory W. Sullivan, undated (received in April 2002).

A1: Letter from the Office of the Inspector General to the Department of Education

The Commonwealth of Massachusetts

Office of the Inspector General

ROBERT A. CERASOLI
INSPECTOR GENERAL

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December 18, 2000

David P. Driscoll
Commissioner
Department of Education
350 Main Street
Malden, MA 02148

Dear Commissioner Driscoll:

Thank you for your letter of December 7. I am pleased that my Office's work has assisted the Department of Education (DOE) in its efforts to provide technical guidance to charter schools.

I appreciate your providing my Office with a copy of the revised contract between the SABIS International Charter School (the School) and Springfield Education Management LLC (SEM). My Office's review of the revised contract shows that some changes were made in response to my Office's recommendations regarding the earlier version of the contract executed by the Board in March 2000. However, I feel compelled to advise you that the revised contract does not address the major concerns outlined in my November 2000 report and, in some areas, further increases the risks to the School. This letter briefly summarizes the major weaknesses of the final contract based on my Office's limited review.

1. **Like the 1995 contract and the draft contract executed last March, the revised contract fails to specify the services to be delivered by SEM or the management staff to be paid by SEM in exchange for the management fee.**

My November 2000 report pointed out the substantial management fees charged by SABIS Educational Systems, Inc. – which amounted to more than $950,000 during the first four years of the contract – appeared excessive in view of the fact that the School was paying its own employees to administer the School's business operations. Like the previous contracts, the revised contract states that SEM will be "responsible" for a series of tasks and functions that have been and will continue to be performed by staff paid by the School. Moreover, the revised contract does not require SEM to provide and pay staff to manage the School. In essence, the revised contract requires the School to pay SEM six percent of the School's public tuition revenues – at least half a million dollars in annual fees – but does not require SEM to provide specific services or staff in return. The School should not be permitted to dispense education funds to SEM under this fundamentally flawed and vulnerable arrangement.

2. Like the previous contracts, the revised contract authorizes SEM to be reimbursed for expenses without specifying the allowable reimbursements or requiring SEM to submit invoices substantiating its reimbursement requests.

Although SEM will receive management and license fees under the contract, the contract also entitles SEM to reimbursement for expenses related to performance of the contract. The contract indicates that the Board will approve for reimbursement only those expenses determined to be "beyond the scope of the management services for which SEM is being compensated by the management fee." However, because the contract does not specify the services to be provided by SEM in return for the management fee, this provision has little meaning and cannot be effectively enforced. My November 2000 report found that the Board of Trustees had authorized more than $300,000 in questionable and unsubstantiated reimbursements to SABIS Educational Systems, Inc. The revised contract provides no meaningful safeguards to prevent a similar scenario in the future.

3. The budget approval provisions of the revised contract appear to violate the charter school law and will undermine the capacity of the Board of Trustees to supervise and control the School's finances.

Under the charter school law, the Board of Trustees is responsible for supervision and control of the School and for development of the School's annual budget. The budget is an essential public policy tool that serves as a guide for School expenditures and ensures that School funds are spent in accordance with the Board's decisions and priorities. As the public body responsible for governing the School, the Board is thus obligated under the charter school law to approve a budget that reflects its decisions and priorities each year. However, the revised contract requires the Board of Trustees to reach agreement with SEM on the School's budget each year. Furthermore, the revised contract provides that any "open issues" on which agreement has not been reached must be referred to binding arbitration. This provision appears to conflict directly with the charter school law; it also raises serious public policy concerns. The interests of a public school may differ from those of a private, for-profit company providing services under contract to the school. The Board – and only the Board – should have the final authority to determine the School's budget. No other party should be permitted to overrule the deeply held convictions of the public body charged by law with the responsibility to govern the School.

4. Like the contract executed in March 2000, the revised contract gives SEM excessive control over the School's operating account.

The revised contract states that all funds received on behalf of the School will be deposited *initially* in an account in the name of the Board of Trustees. The contract then states that on a quarterly basis, "funds allocated in the Budget for the operation of the School shall be deposited in a School operating account. Expenditures from the School operating account shall be made only in accordance with the Budget (as it may be modified by agreement from time to time) and upon approval in writing by the Director or the Business Manager to whom the Director may delegate this responsibility." In its response to my Office's November 2000 report, the Board of Trustees advised the Office that the Business Manager is "responsible to the Board." However, the revised contract states that SEM will hire all School personnel, including the Director and the Business Manager. The revised contract also states that the Director "shall report to the Trustees and to SEM." This confusing organizational structure could create conflicts of interest for the Director and the Business Manager, who cannot effectively serve the interests of both parties to the contract.

5. The revised contract contains unfavorable provisions regarding the surplus School revenues to be paid to SEM.

Under the revised contract, the School is required to pay its year-end operating balance, or surplus, to SEM. My November 2000 report recommended against paying SEM the School's surplus on the grounds that this arrangement would significantly increase SEM's potential compensation while eliminating the School's ability to invest in School programs and operations. This surplus provision is also disadvantageous to the School because it creates an incentive for SEM to underbudget revenues and overbudget expenses, and a disincentive for SEM to expend funds in the School's interest.

Moreover, the revised contract prohibits the Board from withholding approval of SEM's proposed budget "for the sole purpose of diminishing year-end operating balances." This language suggests that the year-end operating balance to be paid to SEM will be included in the School's budget, along with the management fee, license fee, and reimbursements to be paid to SEM. However, the revised contract does not specify or set an upper limit on the year-end operating balance that will be included in the School's budget. This open-ended arrangement impedes the Board's ability to allocate public education funds in service of the School's educational mission and poses substantial financial risks to the School.

6. The revised contract contains contradictory provisions regarding SEM's responsibility for the School's operating deficits.

Although the revised contract states that SEM will bear "sole financial responsibility" for any negative year-end operating balance, the contract also states that SEM will be allowed to "recover any accumulated deficits," defined as "prior year losses" in connection with a negative year-end operating balance. The latter provision indicates that SEM will not be required to bear sole financial responsibility for operating losses, even if these losses are caused by SEM's inefficiency. Instead, the latter provision allows SEM to accumulate and "recover" any deficits.

7. The revised contract allows the School and SEM to renegotiate the contract without competition and could allow a third party to decide the terms and conditions of future contracts.

Although the DOE has advised charter schools that they are required to adopt competitive procurement procedures as a condition of their charters, the revised contract states that the School and SEM have the option to extend the contract for two additional five-year terms. Since the two parties may renegotiate any and all terms and conditions of the contract, this "option to extend" amounts to a noncompetitive negotiation of a new contract. Giving a contractor the option to extend a public contract – and foregoing the benefits of market-driven competition for 15 years – is an unsound contracting approach. If the Board were to exercise sound business practices in future contracts, the Board would establish the major terms and conditions of the contract prior to soliciting competitive proposals from qualified education management companies. However, the revised contract states that "open issues" resulting from the noncompetitive contract negotiations between the Board and SEM may be referred to binding arbitration. In effect, this provision could allow a third party to set the terms and conditions of this public contract. There is no justification for ceding the Board's control over the School's contract to SEM or a third party. SEM clearly recognizes the disadvantages of this approach: the revised contract states that SEM's percentage fees will not be subject to arbitration.

8. Additional contract issues.

My Office's limited review disclosed additional concerns regarding the revised contract, including the following

- The revised contract contains no provisions relating to internal controls, written accounting procedures, competitive procurement procedures, or record-keeping. Since the DOE has advised charter schools that they are required to adhere to sound business practices as a condition of their charters, the contract should incorporate these requirements.

- The revised contract contains an inappropriate reference to the School's lease payments to the company, which are governed by a separate contract that should have no bearing on this contract.

- The revised contract requires the School to use a trademark symbol in its name (i.e., "The SABIS® International Charter School") and to discontinue use of the name if SEM or another SABIS affiliate no longer manages the School. In my view, using a trademark symbol or other corporate logo in the School's name is inappropriate. The School is a public school, governed by a public governing body, serving public school students. The School's name should not, even symbolically, convey the message that the School is a corporate subsidiary.

I hope that this letter clarifies the areas of the contract that continue to pose substantial risks to the School and its stakeholders and that the DOE will advise the Board to redraft the contract to reduce these unnecessary risks. In the meantime, I strongly recommend that the DOE reconsider its decision to recommend approval of the contract by the Board of Education.

I would be glad to make my staff available if you would like to discuss these issues in greater detail. My objective in raising these issues was and continues to be to strengthen charter schools' capacity to serve their current and future students, to promote public accountability, and to protect the interests of the taxpayers whose dollars fund the School.

Sincerely,

Robert A. Cerasoli

Robert A. Cerasoli
Inspector General

cc: Susan Miller Barker, Associate Commissioner of Education
for Charter Schools

A2: Letter (without attachments) from an attorney representing the SABIS International Charter School Board of Trustees to the Office of Acting Inspector General Gregory W. Sullivan

BR&G

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April 18, 2002

VIA FEDERAL EXPRESS

Ms. Pamela Bloomfield
Deputy Inspector General for Management
Office of the Inspector General
State House Station
P.O. Box 270
Boston, MA 02133

Re: SABIS International Charter School, Springfield, Massachusetts

Dear Ms. Bloomfield:

We are writing in response to your letter of April 2, 2002, in which you requested a summary of the actions of the Board of Trustees ("Board") of the Sabis International Charter School ("School") relative to the November 2000 report from the Inspector General ("Report"). This letter presents information based on the outline of the findings contained in the Report. We trust that you will conclude that the information presented demonstrates the commitment of the Board of Trustees of the School ("Board") to ensure that the School's performance in the business area matches its excellent academic performance.

1. Contract oversight practices: School relationship with SABIS, Inc.

(a) Management fees were paid to SABIS, Inc., yet on-site School staff administered daily business operations.

The Board has entered into a new management contract ("Management Contract") with Springfield Education Management LLC ("SEM"), dated March16, 2001, effective as of July 1, 2000, and approved by the Massachusetts Board of Education on March 29, 2001. See Tabs 1 and 2. SEM is a wholly owned subsidiary of the International School of Minnesota, Inc. d/b/a SABIS Educational Systems, Inc. ("SABIS") with whom the Board had its prior management contract.

All the persons who work in the School, including the business manager, have been, and continue to be, employees of the School, paid from the annual operating budget approved by the Board. The School employees are responsible for running the School on a daily basis. The

Management Contract clarifies that the management fee covers SEM employee salaries and costs associated with its employees, all of whom work off-site. See Sections 2.1 and 7 of the Management Contract (Tab 1). Under the terms of the Management Contract, subject to the Board's oversight, SEM is responsible for the education program, the development and administration of the curriculum, the selection of a Director, hiring and management of personnel, professional development of personnel, maintenance and operation of School facilities, and general administration of the School, its staff, and facilities. There is no duplication of effort as the SEM and School employees have different roles and responsibilities.

(b) Corporate support payments to SABIS, Inc. were not specified in the contract nor substantiated with invoices.

Under the Management Contract with SEM, there are no corporate support payments. See Tab 1. The Board will not authorize any more corporate support payments. SEM is entitled to reimbursement for expenses related to the performance of the Management Contract, but it must submit an invoice to the Board, and the Board must find that the expense was necessary and beyond the scope of services for which SEM is responsible under the Management Contract. See Section 2.4.3, Tab 1. In addition, the Finance Committee now reviews on a monthly basis all income and expenses of the School.

(c) The Board did not assume the responsibility for selecting and engaging an independent auditor.

The Board now selects and engages an independent auditor, and has selected Moriarty and Primack, a Springfield firm, to perform this function. See Tab 3. The Board pays the auditor directly.

2. The March 2000 contract would increase the School's exposure to fraud, waste and abuse.

(a) The contract would increase SABIS financial control over the Board.

As set forth above, the March 2000 contract has been superseded. The budgeting and payment procedures have been substantially changed in the Management Contract. (See Section 1.3, Management Contract, Tab 1). Now, the School administration and SEM prepare a budget, which the Board reviews and approves on a line-by-line basis. Disagreement over a proposed budget item is subject to mediation.

Under the terms of the Management Contract, all funds received by the School are deposited into a Board account. SEM is paid on a quarterly basis, and funds allocated in the budget for the operation of the School are placed into an operating account. Funds from the operating account may only be spent in accordance with the budget and upon approval of the Director or the business manager of the School.

The Board has increased financial control over SEM in the Management Contract. The management and licensing fees are based on a percentage of actual tuition amounts paid to the School from the state, which fees were negotiated between the parties. Other compensation, if any, is based on Board approved "surplus" funds determined at the end of the school fiscal year. Such surplus funds, if any, arise from adjustments in state tuition reimbursement, which lags significantly behind Board budget estimates of income from such reimbursement. The Board approves expenditures based on a budget that spends all estimated income on school programs and operations. If actual reimbursement exceeds budgeted estimates of reimbursement, and if all Board identified operational and programmatic needs have been met when the final reimbursement amounts are received, the Board may approve the payment of surplus amounts to SEM. SEM does not control the payment of such funds. Moreover, SEM bears responsibility for any operating deficits, and is entitled to recover any accumulated deficits, if any, only out of surplus funds, if any, and only over the course of the Management Contract.

(b) The contract would increase SABIS, Inc. potential compensation while eliminating the School's ability to invest in School programs and operations.

The Management Contract provides a 6% management fee and a 6% licensing fee to SEM. These fees are paid quarterly, after being invoiced and approved by the Board. The Management Contract also calls for a percentage of any operating "surplus" to be paid to SEM. As set forth above, there is no "surplus" unless and until the costs of all School programs and operations that the Board deems necessary and appropriate have been paid, and SEM bears the risk that revenues will not be sufficient to pay the School's operating costs.

(c) The contract has an indefinite term, reducing SABIS, Inc.'s incentive to provide efficient, high quality services.

The Management Contract is a five-year contract, with an option to extend as well as termination provisions that may be exercised by either party. See Sections 3 and 10 of the Management Contract, Tab 1.

(d) The contract would allow SABIS, Inc, but not the School, to terminate the contract after 5 years.

Both the Board and SEM may terminate the Management Contract. Either party may seek to terminate the contract if it believes that the other party has committed a material breach, e.g. if the Board believes that SEM has not performed in accordance with its Student Outcomes obligations under Section 2.2 of the Management Contract.

(e) The dispute resolution and termination provisions of the new contract would undermine the Board's ability to terminate the contract if SABIS, Inc. failed to perform.

The Board may terminate the Management Contract when there is a material breach, including when SEM has not met its obligations relative to Student Outcomes contained in Section 2.2. The dispute resolution procedure requires a meeting between the parties and a good faith attempt to resolve the dispute. If the parties fail to resolve the dispute, they must submit to binding arbitration. If the arbitrator determines that a party has materially breached the contract, the non-breaching party may terminate the Management Contract.

3. The Board did not accurately document its official actions and policies.

The Board has made changes to its method of operation as a result of the recommendations made in the Report.

- The Board has hired an independent company to tape and transcribe meeting minutes.
- The Board Finance Committee meets every other month, reviews monthly profit and loss statements and reviews the proposed annual budgets, and reports to the full Board.
- The Board has amended its student enrollment policy and no longer provides preferential treatment to the children of Board members. (See Tab 4)

4. Miscellaneous

Since the Report also criticizes aspects of the business operations of the School which were not included in the Report as findings, the Board has addressed those areas below.

(a) The contract with SABIS Inc. contained no performance requirements measuring students' academic achievement.

The Management Contract now provides very specific requirements. See Sections 2.2 and 2.3, (Tab 1).

(b) The School exhibited warning signs of financial problems that, if uncorrected, could threaten the School's future viability.

The Board, while disagreeing that this was ever the case, has enclosed a letter from its independent auditors which states that the School now is financially healthy and has in place appropriate financial controls. (See Tab 5).

If you have any questions or require anything further, please contact me.

Very truly yours,

Peter H. Barry

PHB/rw

208191

A3: Letter from a Trustee representing the Somerville Charter School Board of Trustees to the Office of Acting Inspector General Gregory W. Sullivan, undated (received in April 2002)

Oshima & Associates

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Pamela Bloomfield
Deputy Inspector General for Management
The Commonwealth of Massachusetts
State House Station
P.O. Box 270
Boston, MA 02133

Dear Ms. Bloomfield:

In January of 2001, your office issued a management review of The Somerville Charter School including six recommendations to help us protect the interests of the students and parents of the School and assist us in achieving of educational mission.

The Board of Trustees of the School took each of these recommendations very seriously. I would like to summarize the Board's actions with respect to each of your recommendations.

1. **The Board of Trustees should hire its own staff to oversee the School's business operations, including the contract with Sabis Inc.**

Throughout the Spring of 2001, the Board studied its options of separating the business and educational management functions of the School's operations. It was decided that the Board should include a proposal for separation of duties within the context of its upcoming contract negotiations with Sabis.

2. **The Board of Trustees should consider managing the School's business operations with its own staff when the School's 1996 contract with Sabis Inc. expires in 2001.**

Contract negotiations between the School and Sabis were postponed by mutual consent until April of 2001, awaiting final approval of the Sabis – Springfield contract by the Department of Education and your office. That contract was to serve as the model for the Sabis – Somerville contract. Sabis refused to provide the Board with a copy of the Springfield contract. Our attorneys finally obtained a copy directly from the Department of Education on April 28th.

On June 6, 2001, the Board formed an ad hoc committee on contract review. The committee sent a one-page letter seeking clarification of 6 points in the proposed contract. On June 28, Sabis responded with a one-page letter essentially refusing to negotiate any of the substantive points. The committee responded with an email requesting a meaningful response. Sabis responded on July 27th with a longer, but equally non-responsive letter. Copies of all correspondence are enclosed.

In September, the full Board of Trustees voted to turn contract negotiations over to the Schools' attorneys. At the same time, the Board voted to secure the School's funds and place limitations on Sabis' ability to spend School funds pending the Board's review. The Board hired an independent CPA to advise it on financial issues as well as to perform the annual audit.

Sabis rejected the Board's new financial controls, refused to abide by the terms of the Board's new financial policies, and hired an attorney (Raipher Pellegrino) to represent Sabis' interest. Further, Sabis refused the Board and its representatives access to accounting and financial records, demanded immediate payment of over $1.4 million, and threatened lawsuits against the School.

Over the next few months, the Board attempted to reach a satisfactory compromise to the outstanding issues, intent on minimizing the disruption to its students and educational operations.

On November 20th, 2001, the Board of Trustees voted not to pursue contract negotiations with Sabis, and to take over complete business and educational management of the School as of December 1, 2001.

3. If the Board of Trustees elects to continue to contract for management of the School's business operations, the Board should:

- **Obtain the benefits of market-driven competition by using the best value contracting methods of M.G.L. 30B to obtain competitive proposals from qualified management contractors,**
- **Discontinue the practice of allowing the management contractor to retain all surplus School revenues, and**
- **Ensure that the new contract enables the Board to exercise appropriate oversight and control over School resources and operations.**

This recommendation is moot with dismissal of Sabis, Inc.

4. The Board of Trustees should oversee the preparation and execution of the School's annual budget.

On November 21, 2001, the Board hired an interim director of business and finance. The annual budget, and financial reporting and control are now direct responsibilities of the Board.

5. The Board of Trustees should select, contract with, and oversee the School's independent auditor.

The Board hired an independent CPA, and the School's financial statements have been submitted to the Department of Education.

6. The Board of Trustees should seek guidance regarding its fiduciary duty and establish procedures to comply with the requirements of the open meeting law.

The Board has written procedures to comply with the open meeting law, particularly with respect to executive sessions.

In summary, the Inspector General's report on the Somerville Charter School clearly identified serious management and financial issues that required immediate attention. The Board of Trustees had the unenviable task of trying to adhere to the recommendations of the Inspector General while negotiating with a recalcitrant vendor who was also its landlord. Unfortunately, all of this occurred in the middle of a school year with the education of 650 students at stake.

While the transition has been painful for the many dedicated trustees, teachers and administrators of the School, the students have felt little if any disruption. Sabis took with it its director and two administrators, as well as the School's business manager. Fortunately we were well prepared to fill these positions almost immediately. Not a single teacher or student left on account of Sabis' departure. Sabis has also filed a lawsuit against the Board in federal court and has served us with eviction notices. We have been fortunate to be represented by uncommonly qualified counsel and have secured a new building for the next year.

The School's original contract with Sabis was approved by the Board of Education. In operation, Sabis managed Somerville in very much the same way it managed both Springfield and Foxboro. This Board had no forewarning that its arrangement had severe defects in concept and execution. Other schools would best be served by early notice of disadvantageous management agreements and operational organization.

The Board of Trustees of The Somerville Charter School appreciates the genuine concern shown by your office and appreciates your recommendations. We hope that other schools will be forewarned and forearmed by our experience.

Best regards,

Harold H. Oshima
Trustee
The Somerville Charter School Board of Trustees