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How to Keep Troubled Charities From Failing

By John MacIntosh

The bankruptcy last year of New York's largest social-service charity, FEGS, sent shock waves through the nonprofit world. Nobody expected that a venerable, $250 million organization could go down so fast.

Many trustees and executive directors worried that their organization could be next, disrupting vital programs, stiffing workers, and exposing themselves to personal liability. Some of them asked for our advice on how to avoid a similar fate without becoming so risk-averse that they fatally compromised their missions. At the same time, we saw an increasing number of "zombie" nonprofits: half-dead organizations that had become too weak to provide efficient or effective services.

So we decided the time was right to better understand what concrete steps nonprofits could take to avoid financial calamity and how others — such as donors, banks, and government agencies — might help them. To do this, SeaChange Capital Partners, the nonprofit merchant bank where I am a partner, teamed up with Oliver Wyman, an international consulting firm, to conduct a detailed study of nonprofit risk management.

Our approach was simple: We crunched 990 data (thank you, GuideStar), talked candidly with leaders at nonprofits that got into distress (and at some that seem to be doing things right), and mined banking and insurance risk-management practices for nuggets that would work well for nonprofits. Here’s what we learned:

- It is vital to forecast and evaluate risks — and to identify ways to avoid them or minimize their impact — because most nonprofits live on the edge. We estimate that 10 percent of New York City’s nonprofits are insolvent, and 40 percent have virtually no operating reserve. Less than 30 percent have a healthy level of cash or reserves. Maybe things are different nationally, but I doubt it.
- This is no surprise. Most nonprofits work on intractable problems, often under government contracts that don’t cover the associated costs. They compete for a fixed pool of donor dollars, their work is labor-intensive, and they have trouble recruiting good finance folks — all while operating in a dynamic environment, buffeted by "gales of creative destruction."
- Despite living close to the edge, very few nonprofits have formal processes for evaluating and managing risk. A few things would help a lot. Some are pretty easy and don’t cost much, so there’s no excuse for not doing them. (Can you think of a good reason for a nonprofit not to keep a running list of major risks, guesstimate the cost and likelihood for each, and plan a response?)
- Nonprofits should make managing risk an explicit responsibility of their finance or audit committee, write a statement outlining what risks it will tolerate, develop plans in case of a financial disaster (or even a "living will"), and keep board members in the loop about the operating environment. They should periodically explore the benefits of mergers and other types of collaboration and consider the wisdom of outsourcing certain tasks, divesting particular programs, or even shutting down.
- Troubled nonprofits often routinely run deficits. They can’t recruit and retain a strong chief financial officer. They don’t do explicit planning about what would happen in an array of challenging scenarios or pay enough attention to making contingency plans to cover likely problems. Their trustees don’t get timely, actionable information. Even when they do, they take too long to recognize there is a problem, stall on taking action, and suffer from magical thinking, particularly about fundraising. If this sounds like your organization, be very afraid. Groups that exhibit

these traits won't respond well when a crisis comes. And come it will, for any number of reasons: an executive director departs, a key donor jumps ship, government priorities or funding changes, a real-estate project wobbles, an expensive problem emerges from the past, growth put strains on the organization, and so forth.
- Troubled nonprofits have few options for recovery. Unlike for-profits, they can't attract funding by reducing their price or offering other advantageous terms. There aren't nonprofit turnaround specialists to evaluate and assume financial risks. In fact, most donors run at the first sign of trouble, creating a "run" on the nonprofit.
- Nonprofit bankruptcy is tragic, since scarce philanthropic resources are squandered on transaction costs. But it's not much better when a nonprofit becomes a "zombie" that must use whatever resources it can muster for mere survival. These zombies can stagger on for a long time, and some don't even realize they're zombies (or at least some board members don't).
- The goal of risk management is not survival. It's to have the time, money, and information to make wise choices and thereby avoid disrupting services to those who need them most. Living payroll-to-payroll is also stressful and deeply demoralizing for all concerned. It's not a place where good people — trustees, executive directors, and staff — want to find themselves.

So, if nonprofits need to raise their game, what can the rest of us do to raise our game?

Foundations: You could help your grantees a lot, at little cost to yourselves, by being more creative with your balance sheets. Grants alone are boring, boring, boring. Be brave: Issue letters of credit, make low-cost loans and other program-related investments, and offer guarantees. Be a little looser with general operating support, and let organizations reserve some of your grant money for a rainy day. Ask grantees about their risk-management approaches and share with them strategies that work. Develop respectful ways to share your thoughts about an organization — good, bad, or ugly — with its board. If you really want to know what is going on with your most important grantees, take a board seat.

Banks: Stop gaming the system by making no-risk loans for which you want full credit under the Community Reinvestment Act. Don't trumpet your social responsibility while yanking lines of credit to nonprofits that have nowhere else to go.

Government: Solicit ideas from nonprofits before you tell them what to do, how to do it, and what you'll pay them. (Here you'll find the recent report by the Human Services Council in New York especially helpful.) Obey the new federal rules on paying appropriately for overhead costs or prepare to be sued. If you make nonprofits pay a higher minimum wage (a good thing), increase their contracts so they can do so without going broke. (Do bankrupt nonprofits pay $15 an hour?) Decide whether you care if almost every social-service nonprofit goes bust in the transition to managed care. If you don't care, let them know so they can plan accordingly. If you do care, get organized to help. Pay the full costs of programs (another recommendation in the Human Services Council report). Pay on time, or if you can't do that, pay nonprofits interest on your delayed payments. Differentiate big nonprofits and those that provide vital services for which there is no ready substitute — groups deemed "systemically important" — from the rest.

Helpers: Nonprofits, like mine, that exist to help other nonprofits should stop overhyping our wares. While we do the easy work of "helping," charities on the front lines attack longstanding problems like poverty, violence, education, racism, and injustice. Buzzy ideas such as collective impact — the idea of bringing every kind of group together to solve big problems — as well as social-impact bonds, and venture philanthropy can each play a role, but none are the answer. Nor is risk management, even if it's where we've set our stall. When we claim our favored "solution" is the be-all and end-all, it's demoralizing for nonprofits, who see us as overpaid snake-oil salesmen. (But they can't tell us that, since they are unfailingly polite or because there may be a donor lurking nearby who believes that what we're selling really is the answer.) Even worse, they sometimes believe us.

In short, we've all got a role to play in helping the nonprofit world deliver the vital services on which society depends. It won't be easy or fun, but it should help us avoid having even less fun in the future. Let's get to work.

John MacIntosh is a partner at SeaChange Capital Partners, which co-sponsored the new report, Risk Management for Nonprofits.

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