SeaChange

THINK OUTSIDE THE BOX:

HOW STAKEHOLDERS CAN HELP NONPROFITS FACE THE CHALLENGE OF COVID-19

June 2020

Executive Summary

> *"Everyone has to think outside the box because there is no box."*
> *Governor Andrew Cuomo*

The COVID-19 crisis will drive many nonprofits into insolvency, unable to pay their bills when due or carrying liabilities in excess of their assets. When the crisis abates, those insolvent organizations that have survived will need to recover by finding a path back to effective operations or be recycled, ceasing to exist as independent legal entities while having transferred at least some of their charitable assets (e.g. programs, staff, real estate, financial assets) to mission-aligned organizations able to put them to use.

This restructuring process will be vital to mitigating some of the damage done by COVID-19 to the clients and causes that nonprofits exist to serve. However, it will be difficult, and nonprofits cannot do it alone; stakeholders—foundations, government agencies, membership groups, and technical assistance providers—must assist them in the process.

The State of Nonprofit Restructuring

In the private sector, an entire ecosystem supports the efficient restructuring—both recovery and recycling—of large and medium-sized businesses. This ecosystem includes bankruptcy laws, lawyers, judges, and trustees; restructuring consultants and executives; and "special situations" lenders and investors. Animating this ecosystem is the desire for profit.

This type of ecosystem is largely nonexistent in the nonprofit sector. The fundamental reason is that nonprofits usually fail because of persistent operating deficits or endemic cash flow problems, neither of which can be restructured away even if the associated balance sheet problems are solved.[1] Similarly, the most important nonprofit assets—people, passion, relationships with clients and funders—have value that cannot be monetized, do not survive a prolonged period of distress, and cannot easily be transferred to others.

There are other real-world barriers to productive nonprofit restructuring. Most nonprofits are small, making transaction costs prohibitively high for the formal bankruptcy process to be attractive. Nonprofits lack the fee-paying capacity to retain professionals with relevant restructuring skills, and there has not been sufficient demand to develop a critical mass of pro bono or low bono resources. Nonprofit funders—foundations, individuals, and government agencies—often cut and run at the first sign of distress. Organizations that would make better use of a struggling nonprofit's assets have no mechanism to take them over.[2]

In the absence of a supportive restructuring ecosystem, nonprofits can languish for a long time without either recovering or recycling. The very traits that make nonprofit leaders effective under normal circumstances—passion for the mission, optimism, tolerance for scarcity—too often encourage them to fight for survival past the point where their organization's assets can be transferred to others. Struggling organizations often shrivel to almost

1 The rare exceptions to this are nonprofits saddled with the debt associated with large, one-time capital projects—usually real estate, sometimes technology—that have gone awry. Many nonprofit horror stories begin, "There was this building…"

2 There is no nonprofit version of a "bear hug" or proxy fight. A nonprofit board can only be replaced by the State Attorneys General, in the case of fraud/criminal actions, or by a bankruptcy judge who can replace the board with a Chapter 11 Trustee in certain circumstances.

nothing while still showing a brave face to the world or just fade away; a lucky few are quietly recapitalized by staff, board members and creditors.[3]

By contrast, a struggling for-profit's stakeholders have strong incentives to prevent its assets from wasting away in unproductive situations: owners want to get at least something for their investment; unpaid creditors can, unlike those of a nonprofit, force a for-profit involuntarily into bankruptcy; for-profit board members fear the liability associated with insolvency and do not enjoy the same qualified immunity under the law as those serving on nonprofit boards.[4]

The Impact of COVID-19

The lack of a productive restructuring process for nonprofits has not mattered much in the past. Most individual nonprofits are small, so it is of little systemic importance if any one of them languishes or fails, despite the important work they do and the harm that distress causes for clients and staff. When large organizations have failed, they have generally done so for idiosyncratic reasons and were surrounded by healthy peers who, often assisted by government, were able to pick up the pieces after considerable effort and expense.[5]

However, COVID-19 threatens to overwhelm the current system unless immediate steps are taken to prepare. Nonprofit revenues from all sources—government contracts, fee-for-service, and donations—are down and likely to remain so for years. Many organizations will face unmanageable revenue declines given their liabilities and fixed expenses. For others, retrenchment will entail one-time costs that they do not have the reserves to pay. Cash flow challenges will be daunting as near-bankrupt state and local governments struggle to pay their bills on time or may even renege on contracts at the same time that banks are reluctant to renew, let alone increase, lines of credit.

Widespread distress and failure will be a problem not because nonprofits are valuable per se but because of the associated disruption of services and erosion of charitable assets. Neither a family recovering from abuse, an individual with mental illness, nor an unemployed person getting retrained can afford to stop and start over.

Service disruptions will quickly become permanent if nonprofits that fail are not quickly replaced or restarted but this will be difficult. Few have the type of hard, tangible assets that can survive a gap in service. Given the widespread financial pressure from COVID-19, few peers will be eager to step into the breach to take over services from failing organizations. Philanthropy is not well equipped to provide front-loaded, restart capital at scale. There is no all-powerful profit motive to fuel a post-COVID-19 nonprofit reconstruction.

Widespread distress will also erode charitable assets—among society's most precious resources—if struggling organizations use them for mere survival rather than the effective and efficient pursuit of their missions. Charitable assets will also bleed into the private sector in the form of legal costs, transaction expenses, and interest on debt. Worst of all, they may even be seized by creditors (e.g. a lender foreclosing on a property) and taken out of the charitable realm forever.

3 Staff-led recapitalizations may involve furloughs or working without pay. This can contravene labor laws.

4 There is no legal immunity for gross negligence, intentional harm, or certain tax violations.

5 The Jewish Board incurred $20 million+ in costs when it assumed many programs in the wake of the 2015 bankruptcy of FEGs, then New York City's largest social service agency.

The Need for Stakeholder Action

Mitigating the damage from COVID-19 will depend on thousands of individual nonprofit boards and leaders making difficult, tough-minded, mission-driven decisions. However, this will not be enough; stakeholders must also do their fair share by supporting nonprofits in several new and overlapping ways.

1. Develop a Restructuring Corps

The sector needs a cadre of people with the skills, experience, and passion to get involved in troubled situations as board members, pro bono/low bono consultants, lawyers, or interim executives. Although existing support organizations—law firms, pro bono legal clearinghouses, technical assistance providers—have a role to play, the people most able to help will have real-world restructuring experience, most likely in the for-profit sector.[6] The need for this cadre is particularly acute as the new Small Business Restructuring Act (see Appendix) may actually provide a mechanism for smaller nonprofits to restructure, but only if they have the help to take advangate of it.

2. Provide Transaction Support

Sustained collaborations (e.g., mergers, programmatic alliances, back-office sharing, and divestments), wind-downs and dissolutions will be vitally important—and more prevalent—as nonprofits respond to the challenges associated with COVID-19. Stakeholders should encourage and support nonprofits in the difficult work of pursuing these transactions by providing appropriately structured funding, creating confidential venues for discussion, and modelling norms that destigmatize and normalize the activity.[7]

3. Offer Structured Finance

The most common form of foundation support—the restricted one-year grant approved by the board on a calendarized basis—is ill-suited to the needs of the moment. Foundations have already taken a first step to address this by coming together in emergency relief grant funds and by relaxing the restrictions on their current grants. Now they should address other areas of emerging need:

- Transaction Costs: Nonprofits incur unavoidable out-of-pocket costs when exploring or implementing mergers and other forms of sustained collaboration, as well as divestments and planned dissolutions. Funders should set aside grant allocations (perhaps though multi-funder grantmaking funds) to support these costs.
- Restart Funds: Nonprofits that are hibernating in response to COVID-19 or in the throes of a restructuring may not need funds immediately or may be viewed as too risky by potential funders given the inherent uncertainties. However, they may benefit greatly from a commitment by funders to provide "restart" funding in the future provided certain conditions have been met. These conditions might include continued involvement by key staff and board members, a solvent balance sheet, a minimum

6 Would-be corps members are hard to identify, but a public call to arms by a leading national foundation might bring them out of the woodwork. For an interesting perspective see How to Save Our Nonprofit Ecosystem: Lessons from Public Health.

7 Several communities have established these types of funds. See the Sustained Collaboration Network. This funding should be incremental to normal grantmaking.

amount of committed funding, a viable reopening plan, access to facilities, etc.[8]

- Distressed Debt Purchases: An increasing number of nonprofits will find themselves with unmanageable levels of debt that erode charitable assets (through fees and interest expenses), distract and demoralize leadership, and depress donations. The lenders will likely have written down these loans but they may still struggle to collect on a cost-effective basis given the small loan sizes, weak unsecured creditor rights, public relations, political, and community challenges, complex countervailing covenants (for gifts or real estate), and legal costs. The best result for both the nonprofits and the lenders may be for a philanthropic third-party—perhaps a current supporter—to buy these debts at a (deep) discount and then restructure them to be more favorable to the nonprofit while still allowing for repayment.[9]

- Debtor-in-Possession Funding: Even those nonprofits with a high likelihood of a successful recovery need funds to operate while restructuring. Restricted grants and loans can be made that are available for certain purposes—e.g. continuing to deliver programs or transferring them to others—yet protected from creditors and vendors. These funds are straightforward to provide, as usage restrictions on donated funds under state charitable law are binding even in bankruptcy.

4. Establish Supportive Institutions and Processes

In the 1980s and 1990s, one-third of all savings and loan associations failed. In the wake of the 2008 financial crisis, banks and investment banks were similarly stressed. More recently, there has been widespread distress among private colleges, particularly in New England. In each case, the relevant government agencies developed mechanisms to support responsible self-determination by organizations under duress, to provide early warning of organizations on the brink of failing, and to limit the damage from those that did. In response to COVID-19, government should explore analogous mechanisms for nonprofits:

- Vehicles to Receive Failed Institutions: The Resolution Trust Corporation was established to efficiently recycle failed savings and loan institutions and mitigate the associated damage. Similar pre-authorized entities might be created to temporarily assume, as trustees or receivers, otherwise disrupted assets and services in areas where multiple systemically important nonprofits are at risk.[10] Private funders should explore setting up distress-focused fiscal sponsors to play a similar role for at-risk nonprofits in particular sectors or geographies.

- Differentiated Oversight: After the 2008 financial crisis, certain large financial institutions were deemed "systemically important" and subject to different oversight. Earlier this year in the wake of several damaging failures, Massachusetts passed the "Act to Improve Financial Stability in Higher Education," changing the nature of the relationship between private colleges and their regulators. State and local government should

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8 Trusted intermediaries—CDFI's, community foundations—could structure and manage these funds. Here are sample templates for consideration.

9 SeaChange bought secured debt from the existing lender, almost doubled our money, and injected the profits as a grant (see How We Saved Healing Arts). These purchases can be treated as Program Related Investments.

10 In New York State, organizations working with the developmentally disabled and sheltering the homeless appear to be at greatest risk. These nonprofits are government's partner in delivering constitutionally-mandated elements of the social safety net. It will be a human tragedy and a political embarrassment if they are allowed to fail willy-nilly.

designate certain nonprofits as “systemically important” and engage with them in a different way from the contract-based, procurement-driven approach that has proven utterly ineffective in identifying organizational issues on a timely basis.[11]

- Process Improvements: Nonprofits pursuing mergers, asset sales, program transfers, and dissolutions face a labyrinth of requisite approvals from disparate, siloed government agencies. Not only is this inefficient, but it takes time that distressed organizations may not have. State and local government should map the current process and work to streamline it to the extent possible under the law.[12]
- System-Level Planning: In areas where nonprofits are de facto extensions of government (from a financial standpoint) in providing statutorily mandated services, Berger Commission-like processes should be used to make thoughtful, transparent, fact-based recommendations for how to rationalize the current system to best maintain services in the face of reduced resources. In areas heavily reliant on institutional philanthropy, (e.g. arts and culture) leading foundations should be open to the benefits of coordinated, system-level decision making despite the challenging power dynamics inherent in any such approach.

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These proposals will strike many stakeholders as risky, naive, or impractical. However, each one has been proven effective in other contexts and could make a real positive difference to the clients and constituents of nonprofits. Denial, timidity, or “business as usual” by stakeholders will make the terrible plight of nonprofits even worse. The once-in-a-lifetime challenge of COVID-19 demands bold responses by committed stakeholders. Nonprofits cannot be expected to do the work alone.

11 Neither New York City nor New York State knew anything about FEGS’s problems despite voluminous contract-level reporting. Children’s Community Services became the second largest social service partner to New York City despite obvious red flags that any thoughtful organizational oversight regime would have revealed.

12 The delays will get worse without a redesign given the likely increase in approvals being sought.

Appendix

The Small Business Reorganization Act ("SBRA")

Although "insolvent" and "in bankruptcy" (sometimes called "bankrupt") are often used interchangeably, they are different. "Insolvent" describes a financial condition—unable to pay bills when due or liabilities exceeding assets—while "in bankruptcy" is a legal status. Many organizations are insolvent long before filing for bankruptcy protection in federal court, many insolvent organizations never file, and others use the threat of filing to facilitate an out-of-court restructuring. While unsecured creditors can force a for-profit business into bankruptcy for nonpayment of debt, only the board can put a nonprofit into bankruptcy.

The Bankruptcy Code provides two paths for insolvent organizations to restructure:

- Chapter 7 provides for the liquidation of all assets, with the proceeds being distributed to the creditors according to the priorities of the bankruptcy code. Upon filing, a trustee is appointed to carry out the liquidation, and neither management nor the board has much further role in the business. While unpaid creditors can force a for-profit business into Chapter 7, that is not true for a nonprofit, where only the board can elect to file for bankruptcy.

- Chapter 11 provides a mechanism for reorganizing with the goal—not always achieved—of emerging from bankruptcy as a stronger, solvent organization. Upon filing, all creditors are automatically "stayed" from attempting to collect—through incessant calls, nasty letters, or legal action—what they are owed.

During the stay, management continues to operate the organization—as the so-called "debtor in possession"—under the supervision of the court. The organization can also choose to accept or reject each of its existing contracts, but it must pay its ongoing expenses as well as its lawyers, fees to support the "committee" representing its creditors, and fees to the US Trustee's office. Organizations often seek "DIP financing" to provide the funds necessary to operate while in bankruptcy, provided that willing lenders (or donors) can be found. The "automatic stay" gives the organization time to explore different ways it might reorganize by merging with another organization, selling assets, transferring some programs to financially stronger organizations, or negotiating with creditors to reduce what it owes.

The goal of Chapter 11 is a court-approved Plan of Reorganization, providing for the restructuring of the company's balance sheet so that it is once again solvent and able to operate for the foreseeable future. The organization can propose a plan to the court, as can its creditors. The approved plan can be "consensual," to which all parties have agreed, or a "cramdown," under which creditors are forced to accept less than they have agreed to. Upon court approval of a Plan of Reorganization, creditors have no further claim on the company other than pursuant to the plan. A Chapter 11 filing may convert to Chapter 7 if the court sees no viable path forward. It can also appoint a trustee if it deems the board incompetent/absent.

There are important differences between how nonprofits should operate in bankruptcy compared with for-profits, as well as complex legal issues given the inherent conflict between state charitable law and federal bankruptcy law. These include the duties of the board, restrictions on the use (or sale) of assets and grants, and the rights of creditors. As a general rule, the board has no obligation to maximize value for creditors, and the absence of shareholders may allow an incumbent board to stay "in control" even if creditors do not get a full recovery.[13]

The Chapter 11 process attempts to strike a balance between the rights of creditors and the priorities of the organizations. For distressed organizations, it provides some benefits vis-à-vis trying to restructure outside of bankruptcy:

- An Automatic Stay provides temporary relief from collection actions;
- The opportunity to restructure the balance sheet, reducing debt to a manageable level in order to continue to successfully operate;
- The opportunity to merge and/or transfer programs to stronger nonprofits;
- The ability to reject (or transfer) any undesired contracts, including leases;
- The ability to close any no longer viable operations to preserve the whole;
- The ability to protect the board and management from liability related to difficult business decisions, since all material actions must to be approved by the court.

At the same time, it has negative features:

- The stigma attached with being openly "bankrupt" rather than just quietly insolvent. (This has significantly abated in the for-profit sector, with many major companies successfully emerging from Chapter 11. The reality of COVID-19 may have the same de-stigmatizing effect for nonprofits);
- Bankruptcy is legally and procedurally intensive and therefore too expensive for small organizations[14];
- The drain on management time and resources (the complexity of Chapter 11 often means that management has difficulty managing the business while managing the bankruptcy process).

The statistics suggest that the cons outweigh the pros in the eyes of most nonprofits given that fewer than 50 nonprofits file for bankruptcy each year although many more are insolvent.[15]

The Small Business Reorganization Act took effect in February 2020. For the first time, the SBRA makes it feasible for small organizations to reorganize under Chapter 11 of the US Bankruptcy Code. Although it was designed for small businesses, most experts believe it applies to nonprofits as well. We estimate that more than 95% of nonprofits have liabilities of less than $7.5 million and would therefore be eligible for the SBRA.[16]

13 In for-profit restructuring, when debt holders do not get a full recovery; they often receive control (i.e. ownership) of the company.

14 Costs are largely fixed; an organization that is ten times larger still needs only one creditors committee, one US trustee, and one law firm.

15 See www.creditslips.org

16 Originally limited to organizations with under $2.7 million in liabilities, the limit has been raised to $7.5 million

SBRA was designed to provide a restructuring alternative that would be feasible for small companies by making it less costly, faster, and with a greater likelihood of success. The key features are:

- No creditors committee (the debtor needs to pay committee's expenses in normal Chapter 11);
- No fees to US Trustee's office;
- Only the debtor can file a plan of reorganization, which can be much simpler and does not require a detailed disclosure statement. It must be filed within 90 days, although it can be filed sooner;
- The debtor has significant leverage against unsecured creditors. The court must approve any plan under which all of the debtor's "projected disposable income" goes to the creditors for 3-5 years. "Disposable income" is the amount not necessary for the "continuation, preservation, or operation of the business" which, for most nonprofits, is probably close to zero.[17]

Although the SBRA is new and largely untested, we believe it offers a viable way for nonprofits with balance sheet problems to restructure if funders are willing to support them during and after the bankruptcy process. Funders should educate themselves, their grantees, and local technical assistance providers about the SBRA and be prepared to use it in recovery/recycling and to defend charitable assets from leaking into the private realm.

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because of the COVID-19 crisis.

17 After the time period, if payments have been made according to the plan, the debtor receives a discharge and is free and clear of all debts.

SeaChange champions nonprofits facing complex challenges and is the partner of choice for funders seeking to help. We offer grants, loans, consulting, and referrals. **SeaChange** has been directly involved in a number of restructuring situations in a variety of capacities. This note is based on this first-hand experience as well as discussions with nonprofits, technical assistance providers, foundations, and government about how to respond in the face of COVID-19.

This briefing note is the latest in a series which includes:

- The Financial Health of the US Nonprofit Sector
- Risk Management For Nonprofits
- Tough Times Call for Tough Action
- Too Big To Fail
- Main Street Lending 2.0

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