

SeaChange

TOUGH TIMES CALL FOR TOUGH ACTION

A DECISION FRAMEWORK FOR NONPROFIT LEADERS & BOARDS

MARCH 31, 2020

Executive Directors and Boards will need to take decisive and difficult action if the nonprofits they lead are to [survive the COVID-19 crisis](#). In our role as the champion of nonprofits facing complex challenges, [SeaChange](#) has a decade of experience working with nonprofits with respect to risk management, lending, financial analysis, mergers/collaborations, and restructuring/dissolution. We have already been approached for advice by more than a dozen organizations as they grapple with the current situation. This briefing note summarizes the advice we have given them and the best practices we are seeing in the field.

## 1. Refocus on the Mission

Boards and Executive Directors must remember that the foundation for all their decision-making should be: “*What best advances the long-term mission of our organization?*”<sup>1</sup> A nonprofit’s reason for being is its mission. Board members have a duty of obedience to ensure that it is governed with the mission in mind. Concern for the mission must take primacy over concern for history, vendors and partners, funders, and even staff. Organizations unclear about what their mission really is should figure that out quickly in order to provide a coherent foundation for decision making.

## 2. Understand Your Type of Organization

In response to COVID-19, organizations appear to fall into three broad categories: **Hibernators**, **Responders**, and **Hybrids**.

**Hibernators** are completely unable to operate during this crisis. (They may pretend otherwise, but this will waste time and resources.) Hibernators include arts organizations whose venues are closed, after-school providers who no longer have students, technical assistance firms whose clients have gone away, etc. These organizations need to reduce their monthly cash burn-rate to the absolute minimum and mothball themselves in the hope of surviving until spring with enough resources to restart.

**Responders** have seen the demand for their programs go up because of COVID-19. At the same time, they face increased difficulty and cost in delivering these essential programs safely. (One large responder has seen weekly costs increase by \$50,000 to keep front-line staff in place with appropriate masks and cleaning supplies; another is paying double-time.) Responders include primary health clinics, homeless shelter operators, food pantries, operators of residential facilities for the developmentally disabled, etc. The challenge for responders is having the cash to maintain services. Early action by government suggests that it will eventually get the required resources to responders, but timing is likely to be an issue. The government is aware—or should be made aware—that the failure of any large responder will wreak havoc in the local community.

**Hybrids** offer programs that can be provided, to some degree, despite the

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<sup>1</sup> There is no long-term mission unless the organization survives in a minimally viable state or is able to transfer some (or all) of its program(s) to organization(s) able to continue them.

COVID-19 crisis but which are not directly related to reducing its spread or mitigating its short-term impact. These programs might include workforce training and development, advocacy, reentry programs for the formerly incarcerated, etc. The decisions facing hybrids are more complicated than those facing hibernators or responders since they have greater degrees of freedom with respect to how they deliver their program(s)—lower dosage may still mean higher costs given COVID-19 related challenges—and how they approach staffing levels. They also face the greatest uncertainty with respect to how funders will view their importance during the crisis and its aftermath.

### 3. Conserve Cash

Rule number one in any crisis is to conserve cash. Organizations should review each and every item in their budget and most recent balance sheet looking to reduce expenses, delay payments, and/or accelerate revenue.

**REDUCE EXPENSES:** For many nonprofits, most expenses are personnel-related (including part-timers and consultants), followed by rent, and then “everything else.” Staff reductions, asking higher paid staff to take reduced/deferred pay, and furloughs should be considered.<sup>2</sup> Nonprofits leasing space should immediately review their leases to understand grace periods, the landlord’s ability to tap the security deposit for rent in arrears, and any *force majeure* clauses allowing for nonpayment. Nonprofits should not pay the rent before asking the landlord what type of program they are offering for reduction or deferral. Then they should consider carefully whether to pay the full rent, a discounted amount, or no rent at all. In some states, eviction stays have been put in place or the courts have been closed, giving cash-starved nonprofits the upper hand with landlords. In the current market, even landlords able to evict tenants are unlikely to find takers for the space and might prefer a discounted rent to no income at all. Nonprofits should take the same approach with lenders by asking for a deferral of any cash interest or principal payments that would otherwise be due over the next few months.

Boards must appreciate that expense reductions will be difficult for many Executive Directors. One way to help is by working with the Executive Director to develop a “zero-based” budget which starts from nothing — no staff, no rent — and builds up to the minimum levels required. (Larger nonprofits cannot actually start from zero, but the same principle can be applied by asking, “What *must* we be doing?”)<sup>3</sup> Nonprofits should also turn off any automatic direct debits to ensure that expenses—in particular, rent and/or interest—are paid only if and when the organization chooses.

**DELAY PAYMENTS:** Nonprofits should examine each payable by asking, “Do we have

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<sup>2</sup> Nonprofits need to understand the eligibility criteria, amount, *and timing* associated with funding potentially available under the [CARES Act](#) (and others).

<sup>3</sup> Many nonprofits are forced to operate as if they are collections of quasi-independent business units because of the restricted nature of many grants and virtually all government contracts, so the zero-based budgeting exercise is more complex than for a similarly sized for-profit.

to pay this now?” For vendors providing vital, ongoing services, the answer may be yes. For other vendors, while they may moan and groan, there is probably not much immediate action they can take in the face of nonpayment. Any outgoing cash payments above a *de minimus* threshold should require the written approval of the board chair or treasurer.

**ACCELERATE REVENUE/CASH:** Many organizations have funders with outstanding grant commitments and others, including board members and very long-term supporters, who should be reliable despite the crisis. Organizations should ask these core donors to accelerate their grants and gifts. This will bring cash in the door while also giving the organization important information about how its fundraising prospects have likely been affected by the crisis. Nonprofits should also ask funders providing restricted grants to modify those restrictions to allow for more flexibility.<sup>4</sup> In instances where a funder cannot be reached, consider whether restrictions may be lifted by confirming the applicable Uniform Prudent Management of Institutional Funds Act (“UPMIFA”) regulations.

**EXPLORE NEW FUNDRAISING OPPORTUNITIES:** Nobody knows how long the crisis will last, so nonprofits should explore all possible government and philanthropic initiatives offering grants or loans. It is better to raise more cash than ends up being needed than to risk running short.<sup>5</sup> Some of these initiatives are of finite size and may quickly run dry; others require spending only on certain items—often payroll—which may change the analysis with respect to expense cuts. Read the fine print since some programs provide *reimbursement* for certain costs, which may not help with immediate cash flow unless the future payments can be borrowed against now.

#### 4. Resist Magical Thinking; Shorten Time Horizons

Nonprofits under duress can suffer from magical thinking.<sup>6</sup> They often let too much time pass before taking action. Given that most nonprofits have almost no margin for error (i.e. cash) even in normal times,<sup>7</sup> magical thinking or delayed decision-making can often be fatal. Executive Directors and Board Chairs need to impress upon the broader set of trustees—even those that think “I never signed up for this!”—that their time and *money* is more important than ever. This approach ensures that the organization remains nimble in a fast-moving crisis while keeping trustees appropriately involved. To avoid magical thinking, boards should pre-commit to difficult actions if certain events come to pass. For example, an organization could

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4 Funders may have been too quick to remove *all* restrictions on their restricted grants in response to the crisis. They might consider changing the restrictions to terms like, “can be used for any purpose except paying rent or accounts payable.” The nature of restrictions can also be quite [vague](#), allowing nonprofits to “sin first and repent at leisure.”

5 Some boards have a visceral reaction against borrowing and have self-imposed restrictions on borrowing. These should be lifted, although loan proceeds not needed immediately could be put into a separate account to be accessed only with board approval. Many of the loans being offered have very soft terms, including pre-agreed forgiveness under certain circumstances.

6 Magical thinking is the belief that one's own thoughts, wishes, or desires can influence external circumstances.

7 Less than half of nonprofits have more than three months of cash. More information is available in this [report](#).

pass a resolution now that if cash falls to a certain level, then they will stop paying the rent or will discontinue a certain program.

## **5. Explore M&A, Divestment, Restructuring, or a Dignified Dissolution**

Any organization concerned about whether it will be able to endure as a standalone entity may still have time to explore a merger or other similar transaction, but this possibility will quickly evaporate as time passes and cash depletes. In our experience, sensible mergers normally take 6-18 months to explore. This crisis may motivate people to move more quickly, but less than six months remains impractical.

Organizations also need to ensure that they have the time and resources, both staff/board time and financial, to dissolve in a thoughtful, salvage-at-least-some-of-the-mission way if that becomes the best outcome given the circumstances.

## **6. Understand the Nexus of Mission, Cash, and Control**

“Tough-minded,” “hard-nosed,” and “ruthless” are not adjectives that most nonprofit leaders want to embrace. Many are not experienced in using the legal system to their advantage, consciously making choices that will leave people they care about very unhappy, or dispassionately considering, “Who can do what to whom?” The very qualities that make so many nonprofit leaders great—compassion, risk-taking, optimism bordering on magical thinking, and an orientation to value staff over finances (and sometimes even over the mission)—may work against them in the current crisis. Boards must appreciate how difficult it will be for some Executive Directors to truly prioritize the long-term mission to the extent that it conflicts, at least in the short run, with taking care of staff, especially if those staff are from the very communities they serve, or that it raises complex issues of race, class, or generational privilege. That said, here is a list of some things that nonprofit leaders and boards should keep in mind:

- A nonprofit cannot be put into bankruptcy involuntarily by its creditors.
- A lender—if it also holds the deposit accounts—may be able to freeze a nonprofit’s accounts for nonpayment, though not accounts at other banks.
- Unpaid payroll taxes expose board members to joint and several personal liability.
- The restrictions on a gift cannot be challenged by creditors or vendors even in bankruptcy court. For example, a grant which says, “Must be held in a separate account and used only for payroll” cannot be used to repay debt or rent.
- A nonprofit that shuts down may be able to cancel some insurance coverage and get a rebate. On the other hand, it should reserve the funds to renew coverage which may run out but is critical at this moment (for example, D&O).

## **7. Get Help**

This is a moment when boards must err on the side of being over-involved. Many nonprofit leaders have very little restructuring experience and will need help from their boards in understanding the facts and determining what must be done. Although board members, pro bono lawyers and outside consultants can be helpful, it is quite common in distressed and troubled situations that the Executive Director simply cannot do what is necessary. In some cases, they may be in denial. In others, they may be conscientious objectors who, while recognizing what must be done, refuse to be the one to do it. In these cases, the board should consider asking the Executive Director to take a leave of absence and appointing an interim Chief Restructuring Officer. The CRO can be an internal candidate — potentially the CFO — or an appropriately experienced consultant from the outside.

## 8. Plan for the Future

While dealing with the immediate crisis, nonprofits, particularly hibernators, also need to plan for their post-COVID-19 future. Organizations that weather the crisis still run the risk of faltering later.<sup>8</sup> It is likely that city and state budgets for the next fiscal year are going to be significantly lower given the reduction in tax revenues and the enormous deficits associated with the COVID-19 response. There are early indications that some government agencies may even reduce payments associated with the out-years of existing multi-year contracts. Nonprofits will have very little visibility into the level of support they can expect until the very last moment. Likewise, philanthropy is likely to fall over the medium term unless the market rebounds, despite the rash of special initiatives launched in response to COVID-19.

One very thoughtful hibernator is raising a “restart fund” of grants and loans that can only be used when the crisis is over. This approach may resonate with funders who are reluctant to give to even a well-loved organization given the unknowable costs associated with a shutdown of indefinite length. Organizations with reserves that they are willing to drain in the crisis should still estimate the amount required to restart and should squirrel this money away in a safe, untouchable, and bankruptcy-remote place.<sup>9</sup>

Despite the high level of distress and uncertainty, nonprofits must be in open and regular dialogue with their important funders. Yes, these are scary times, but funders and nonprofits are “in it together.” Not only are funders—as human beings—feeling the same fear and anxiety as nonprofit leaders, but they also have their own anxieties about what their boards will do with respect to funding priorities and levels. It’s a recipe for disaster to pretend that things are “business as usual” until the next grant application is due, only to learn that the funder has shifted priorities or cut back grant sizes.

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8 Some nonprofits that received significant TARP or Hurricane Sandy funding overspent and failed after the crisis.

9 There may be a role for structured finance in restart funds: DAF’s, escrow agreements, and binding commitment letters can play a role in allowing foundations who want to count their grant in the calendar year to support organizations who may not need it until next year, if at all. Restart funds might also allow a nonprofit to file for bankruptcy to defease its liabilities while still having the funds to emerge when the time is right.

We recognize that the sense of urgency in this note is ahead of where many nonprofits are in their planning. While some may accuse us of being alarmist, we are confident in our overall tone and direction although no specific advice should be accepted (or flatly rejected) without further thought. The sad truth is that, without strong action by individual boards and leaders, COVID-19 threatens to be an extinction-level event for nonprofits. Those that fail will not easily be replaced, as few have the type of hard, tangible assets that can be brought back into action after a gap in service. There is no all-powerful profit motive to fuel a reconstruction. Philanthropy is not good at providing front-loaded, restart capital at scale.

SeaChange is working hard to deploy our resources to help nonprofits and funders with the complex challenges that they face as a result of COVID-19. We welcome your feedback on this note and encourage you to forward it to other nonprofits board members, executive leaders, and funders. We stand ready to connect with any organizations who think that we might be of assistance.

SeaChange is the champion of nonprofits facing complex challenges and the partner of choice for funders seeking to help. SeaChange has been active over many years in the financial analysis of the nonprofit sector. This briefing note is based on these reports which include:

- [The Financial Health of the US Nonprofit Sector](#)
- [Risk Management For Nonprofits](#)
- [Philadelphia Risk Report](#)
- [Overhead for Trustees](#)
- [New York City Contract Delays](#)
- [Closing the Gap: A True Cost Analysis](#)

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