THE ACTIVIST FOUNDATION PRESCRIPTION:

How foundation investments in an activist fund can drive nonprofit performance and create taxpayer value

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Introduction

Hedge fund and private equity activists have performed an invaluable role in the commercial sector by intervening effectively in the governance, strategy, capital allocation, and management of their portfolio companies to maximize shareholder value *(Alon Brav)*. Less recognized, but of even greater import for the larger economy, management apprehensions over becoming an activist's target have served as a much-needed check on all corporate leaders, increasing accountability for the impact of their decisions on shareholder returns.

No comparable business model has yet emerged in the voluntary sector to enhance the value of public assets despite clear evidence of systemic failures and value destruction similar to that evidenced by failing private enterprises. The need for such an actor to emerge is especially acute in the human services sector, where changes in that industry's operating environments are harbingers of rapid consolidation. Evidence from the health insurance and hospital segments suggests that nonprofit human service assets will be converted to for-profit control over time at sub-optimal valuations due to structural impediments associated with the nonprofit form.

Alone among nonprofit stakeholders, enlightened foundations can adopt the role of nonprofit activists and the business model appropriate to that role in order to introduce constructive change to underperforming nonprofits. Focusing specifically on the human services segment, we *(1)* identify the reasons why nonprofits have been unable to adapt to the changing industry environment, *(2)* explain why foundations can and should adopt an activist approach in response, and *(3)* propose an organizational structure, strategies and tactics that foundations can adopt to maximize the value of the public's historic charitable investment so that this capital can ultimately be reinvested in alternative public goods.

To paraphrase Carl Icahn, an arbitrage exists when assets sitting in a nonprofit corporation are valued below what they would attract in an auction, or under different management (*Page 192 Dear Chairman)*. By adopting the structure and role of hybrid activist funds, foundations can intervene in the marketplace to assure that the public benefits from this arbitrage; if foundations shirk this responsibility, it is certain that private investors will reap these economic benefits instead.

I. Background

Investor-owned companies have amassed growing market shares in segments of the human services industry once dominated by nonprofit providers. These incursions mirror the penetration of the nonprofit health insurance industry by investor-owned companies in the 1970's, and their subsequent inroads into the nonprofit hospital marketplace. The allure for investor-owned healthcare enterprises is simple: between June 2010 and May 2015, the S&P 500 health-care sector climbed a whopping 162 percent – the best performance of any sector – and significantly more than the 97% return on the S&P 500 during that time *(Borzykowski)*.

While the pace of conversion of human services organizations from nonprofit to investor-owned has been glacial, there are reasons to anticipate accelerated change in future years *(Deloitte Center for Health Solutions)*. These reasons include the dearth of suitable for-profit targets available to investor-owned consolidators (several of whom have revenues in excess of $1 billion), the growing popularity of at-risk contractual arrangements that offer better capitalized providers a competitive advantage, the evolution of performance and outcome metrics that increase the significance of technology in the provision of care, and importantly, historically low interest rates. While not yet widespread, the trend towards integrating behavioral health and primary care, and the growing focus on the social determinants of health, will also impact the pace of consolidation by introducing a new set of buyers – acute care hospitals – into the emerging marketplace for control of nonprofit human services providers.

These market dynamics place many nonprofit providers at an overwhelming competitive disadvantage because their access to capital is limited by the non-distribution constraint (which precludes them from securing equity investments) and because capital within the nonprofit segment cannot be efficiently redeployed between healthcare industry sectors or providers within these sectors. Limited capital access, in turn, prevents prospective nonprofit consolidators from emerging and thereby inhibits the achievement of scale (i.e. revenue growth) necessary to make essential technology investments affordable. For this reason, it may be that the eclipse of nonprofit providers by investor-owned competitors is inevitable. In that event, governance and managements of nonprofits face strategic alternatives focused on coping with decline – not decline of their industry - but rather decline of their nonprofit business model. The strategic consequences are analogous to that of commercial competitors in industries such as vacuum tubes and video rentals who

confronted the challenge of crafting end game strategies to maximize shareholder returns in the face of deteriorating demand *(Kathyrn Rudie Harrigan)*.

Not surprisingly, this approaching storm has gone largely unrecognized by nonprofit boards and managements, in no small measure due to the very high exit barriers faced by nonprofit service providers. These barriers consist primarily of the emotional commitment of trustees to the nonprofit organizations they govern, and to managerial resistance driven by the economic consequences of decline and divestment on executives, who research shows always wait too long before abandoning alternatives to disinvestment *(Bart M. Lambrecht)*. These exit barriers invite distorted perceptions regarding the likely pace and extent of decline, resulting in unduly optimistic forecasts of future prospects. The consequence of this self-deception is a large scale destruction of the public wealth invested in nonprofits, as price warfare slowly drives weaker nonprofits out of business, while the few better capitalized nonprofits commit their remaining resources to competing in inhospitable markets in the hope of a market revitalization that will never come.

It is noteworthy that investor-owned consolidators are only reluctantly looking to acquire nonprofits as they execute their roll-up strategies. This reticence stems from the numerous challenges and extended process associated with the acquisition of nonprofits by investor-owned companies and the difficulty valuing enterprises that have not been operated with the goal of maximizing returns on invested capital.

Nonetheless, to the extent that human services nonprofit providers can be acquired at a discount because of their modest margins, investor-owned providers pay substantially reduced multiples compared to transactions with organizations with substantial revenues and superior performance histories. This circumstance in fragmented industries invites the adoption of roll-up strategies, whereby an investment is made in a platform acquisition that subsequently expands revenues via multiple acquisitions, and exiting thereafter at a higher valuation multiple once the platform achieves scale. In the absence of national or large regional nonprofit consolidators, the potential arbitrage gains stemming from consolidation find their way into shareholder's pockets rather than remaining in the public domain.

To understand why there are no national nonprofit consolidators, it is critical to recognize three structural deficits of the nonprofit corporate form and their effects. These structural deficits – the inability to access capital, the inability to redeploy existing capital between providers and across industry segments, and pervasive governance failure - prevent nonprofit providers from accumulating the capital, and adopting and executing the strategies necessary to compete successfully with their investor-owned counterparts. Once these obstacles are understood, an alternative business model can be designed to maximize the value of the public's vast historic investment in human services as the industry transitions to investor-owned providers.

CAPITAL ACCESS AND DECLINE When revenues on the income statement increase, then assets on the balance sheet must also increase, which is why growing companies must have the ability to finance expanded investment in working capital and fixed assets. The non-distribution constraint precludes nonprofits from securing equity investments, and so additions to nonprofit equity in most instances are limited to net operating and non-operating income. Because human services organizations typically are engaged in low margin activities, the structural constraint on nonprofit equity effectively limits access to debt as well, since equity constitutes the layer of capital that secures lenders. Even if mortgages on core assets are available as additional collateral security, capital providers focus largely on equity as a measure of overall financial performance and stability. The effect of these factors constraining nonprofit capital access is to limit nonprofit providers' ability to invest in working capital, technology, facilities, and management, and therefore, to participate in industry consolidation and advancement.

As a consequence, nonprofit human service providers have historically grown slowly and organically, and there is no meaningful market for nonprofit control. The nonprofit segment of the human services industry

remains fragmented despite the technology-induced consolidation that has transformed nearly every other segment of the American economy. This business model has served the interests of nonprofit managements, for whom the pursuit of scale economies through business combinations entails risks to their employment.

While these circumstances would seemingly pave the way for industry consolidation led by investor-owned providers, this outcome has been thwarted by several barriers. Foremost among these is the widespread belief among nonprofit trustees that the profit motive is incompatible with the mission of providing human services, compounded by a preference of many public officials and payors for a delivery system comprised of numerous small, undercapitalized, nonprofit providers. Absent financial distress, these factors have often deterred nonprofit providers from responding to business combination proposals from aspiring industry consolidators.

Thus, nonprofit governance finds itself in a situation in which it has failed to achieve scale in a maturing industry, yet is unable to exit due to a self-imposed absence of a market for corporate control. The resulting excess capacity in a maturing industry suppresses the margin expectations of would-be consolidators, whether nonprofit or for-profit. There is growing recognition that this outcome is not serving the public interest, and this recognition has led to a variety of public policy responses, such as the introduction of the low-profit limited liability company, or "L3C," a legal form of business entity that was created to bridge the gap between non-profit and for-profits while facilitating improved capital access. None of these adaptations has proved effective in enabling the requisite capitalization of even a single national consolidator.

CAPITAL REDEPLOYMENT AND DECLINE A liquidity event is the mechanism by which investor-owned companies return capital to equityholders, either through a public stock offering, a leveraged recapitalization, a liquidation, or a sale of all or part of the company to management, another firm, or an ESOP. Generally, liquidity events are triggered by investors seeking to extract their invested capital and any returns thereon in order to redeploy that capital to alternative uses. In part, this decision is influenced by research indicating that when excess cash is available to management it is likely to be invested in projects that destroy shareholder wealth. For investors in human services providers, these alternative uses include reinvestment in a different human services provider with superior earning prospects, investment in another healthcare industry segment, or investment in a different industry entirely.

Unlike their investor-owned counterparts, nonprofits have no equityholders, and hence there are no nonprofit liquidity events. As a result, nonprofit capital is effectively entrapped and there is no nonprofit mechanism other than effective monitoring by governance to prevent management from deploying excess cash in wealth-destroying projects, nor any mechanism to redeploy assets from underperforming service providers to outperforming ones. Consequently, older nonprofits - whose available capital has often been compounding in real estate and other investments for many years – are often in possession of more capital than they can efficiently invest in services, while entrepreneurial providers or small, potentially disruptive nonprofits are unable to thrive due to inadequate capital investment. A secondary impact of this nonprofit structural failure is that debt markets are effectively unavailable to rapidly growing nonprofits because they lack adequate unrestricted net assets, while the same markets fail to discipline shrinking or low growth nonprofits because such firms can service any existing debt and have no need for more.

This circumstance is evidenced by the wide divergence amongst nonprofit peers with respect to the volume of revenues generated per dollar of unrestricted assets *(see Exhibit A, page 7)*. Not infrequently, rapidly growing providers generate high levels of revenues per dollar of unrestricted assets by leveraging their balance sheets to the limit of their ability while better capitalized, often long-established providers build portfolios of unrestricted investments to cushion the occasional operating setback rather than expand services to the maximum prudent level. In a commercial setting, of course, the failure of corporate management to disgorge excess capital via share buybacks or special dividends would constitute an open

EXHIBIT A: REVENUES PER DOLLAR OF UNRESTRICTED NET ASSETS

	ANNUAL REVENUES	UNRESTRICTED NET ASSETS	REVENUES PER $ OF NET ASSETS
Resources For Human Development (PA)	$221,133,839	$19,394,162	$11.40
Lifespire, Inc (NY)	$103,289,400	$11,067,531	$9.33
Psch, Inc (NY)	$97,753,073	$12,584,264	$7.77
Keystone Human Services (NY)	$141,471,367	$22,628,348	$6.25
SCO Family of Services (NY)	$215,975,809	$35,210,859	$6.13
The Chimes (MD)	$183,222,165	$30,105,851	$6.09
UCPA of NYC (NY)	$103,931,000	$18,360,000	$5.66
Bancroft NeuroHealth (NJ)	$104,711,000	$20,977,000	$4.99
FEGS (NY)	$224,544,090	$47,809,453	$4.70
Elwyn (PA)	$265,104,993	$57,906,078	$4.58
Public Health Management (PA)	$161,695,585	$45,911,055	$3.52
Children's Home Society (FL)	$111,122,196	$42,230,892	$2.63
Devereux Foundation (PA)	$391,580,000	$145,045,000	$2.70
Jewish Board Family Services (NY)	$191,977,504	$95,337,745	$2.01
Mosaic (NE)	$212,740,377	$112,843,690	$1.89
Kennedy Kreiger Institute (MD)	$213,535,000	$116,583,000	$1.83

invitation to activists like Carl Icahn (as illustrated most recently in the case of Apple). Nonprofit managements are yet to encounter a similar disciplining force.

In the commercial realm, misallocation of capital serves as the raw material from which hedge funds and private equity firms create vast fortunes; in the nonprofit world, the failure to aggressively employ capital in pursuit of the nonprofit mission invites actions that redirect capital to the private interests of corporate officers. Benjamin Graham, the father of value investing, once wrote: "...The determination of whether capital not needed in the business is to remain there or be withdrawn, should be made in the first instance by the owners of the capital rather than by those administering it"[1]. The public owners of nonprofit organizations are without the means to implement this sage advice.

GOVERNANCE AND DECLINE In addition to its impact on capital access, the non-distribution constraint dilutes nonprofit governance by abolishing ownership's traditional role as the driver of organizational performance and the primary restraint on management's pursuit of its private interests. While uncompensated, volunteer nonprofit trustees sometimes possess broad business and finance credentials, they only infrequently possess technical skills directly applicable to the enterprise they govern, and understandably devote limited hours to their trustee duties. As a consequence, they rarely possess the training and experience required to effectively govern nonprofit corporations, whose goals are often difficult to define and whose outcomes are difficult to measure. The absence of principals motivated and capable of effectively monitoring management, combined with the absence of a market for nonprofit control, often result in a reversal in the power relationship between governance and management that is especially problematic in decline *(see Exhibit B, page 8)*.

While state laws impose duties of loyalty and care on nonprofit boards, these legal standards have proven ineffective, in part because of limitations on the ability of private parties to sue, and in part because Attorneys General are reluctant to litigate against volunteers. In fact, nearly half the states permit nonprofits to adopt protections shielding trustees from liability for breaches of the duty of care!

None of these structural limitations impedes governance of investor-owned competitors, where directors with deep industry experience are incentivized to achieve the clearly defined goal of profit maximization, and a thriving market for corporate control serves as a rigid taskmaster and disciplinarian.

1 Jeff Gramm, Dear Chairman, (New York: HarperCollins Publishers, 2015) 10.

AGENCY COSTS AND DECLINE The rationale for engaging nonprofit organizations in healthcare and human services stems from the need to address the market consequences of information asymmetries that characterize these activities. Historically, consumers recognized that investor-owned providers might exploit these information asymmetries to maximize profits, and so the establishment of enterprises constrained by a non-distribution requirement was intended to redress the contract failure extant in the absence of nonprofits. Experience has provided ample evidence that the non-distribution constraint does not achieve its intended result in industry segments that derive their revenues from fee income rather than contributions, for reasons best explained by agency theory.

Agency theory posits that the interests of principals and agents diverge as a result of the separation of ownership from control, and this divergence occurs in both investor-owned and nonprofit organizations. In investor owned enterprises, shareholders are clearly identifiable as the corporation's principals, and profits are clearly identifiable as the corporation's goal. Principals are incentivized to monitor and deter management conduct not directed at profit maximization, and sub-optimal corporate performance is further constrained by a vibrant market for corporate control. In contrast, neither the principals nor the goals are so clear in nonprofit corporations, and no comparable market for nonprofit control has yet evolved. As nonprofit management performance is difficult to measure, and is not constrained by incentivized monitors or a market for corporate control, agency costs are amplified in nonprofit organizations and pose an even greater challenge to nonprofit governance than to that of investor-owned corporations.

Agency costs in nonprofit organizations take many forms, ranging from actions intended to increase management's remuneration, power, job security and status to malfeasance. Alternately, managers may simply devote suboptimal effort to the management task or engage more than the requisite number of workers to manage corporate affairs *(Marianne Bertrand)*. Advancing its private interests requires management to pursue policies intended to increase its power relative to governance in order to

EXHIBIT B: DECLINE ILLUSTRATED

With revenues of more than $362 million, Devereux Foundation was the nation's largest nonprofit provider of human services at the end of 2004 - far larger than Providence Service Corporation (NASDAQ: PRSC), an Arizona-based publicly-traded company founded just seven years earlier, whose 2004 revenues totaled just $97 million. Ten years later, century-old Devereux's revenues had grown to slightly over $400 million - a compound annual growth rate of just 1.0% - while Providence's revenues had reached nearly $1.5 billion - a compound annual growth rate of more than 31%. Providence's impressive growth over this ten year period was not extraordinary among investor-owned service providers of human services. By 2014, the behavioral health division of Universal Health Services generated 2014 revenues of nearly $4 billion, and Civitas Solutions, Inc. (which markets its services nationally as The MENTOR Network) and ResCare each generated revenues in excess of $1 billion. The key to the exceptional growth of these investor-owned human service providers in each instance was the same: mergers and acquisitions. Meanwhile, not a single human services nonprofit corporation in the United States today generates revenues of even $600 million, and no significant market for nonprofit control has yet evolved.

In the absence of any effective response from nonprofit service providers to the rapid and accelerating capture of market share by for-profit competitors, private equity firms - plush with cash they were unable to profitably deploy during the Great Recession - have now identified human services as a growth industry. Private equity firms currently own multiple platform investments in the substance abuse, behavioral health, developmental disabilities, autism, special education, juvenile justice and foster care segments of human services. Given that these platforms are assured superior capital access, along with the governance and management attributes associated with the private equity business model, there is a sound basis for assuming that these platforms will prove as formidable as their investor-owned predecessors in stealing market share from legacy nonprofits.

gain increased control over nonprofit resources. Management's policy options in pursuing this end are vast as a result of management's superior expertise, its control over critical information, and its position as the nexus of the many contracts that constitute the firm *(Charles W.L. Hill)*. Strategies typically include program, geographic, or payor diversification – which increases complexity and information asymmetry, and consequently, trustees' reliance on management – combined with efforts to influence the size or composition of boards, or to encourage trustee term limits – which disperses trustee power and makes it more difficult for boards to monitor management actions.

Governance of both investor-owned and nonprofit corporations seeks to minimize the opportunistic conduct of management by incurring monitoring costs and by offering economic incentives, but nonprofits' efforts are rendered less effective than the parallel efforts of investor-owned companies due to the difficulty in defining or measuring nonprofit goals, and the relative ineffectiveness of law as a deterrent to self-interested conduct by nonprofit managers.

Nonprofit corporations in decline are especially dependent upon governance for strategic direction because the industry environment exacerbates the ever present conflict of interests between owners and management teams. Indeed, the absence of effective nonprofit governance has prevented or delayed value-creating divestitures or business combinations because managers prefer to remain independent rather than risk discontinuation of their employment *(Black)*.

MARKET DYNAMICS AND DECLINE The human services industry is mature, but not in decline; rather, it is the nonprofit segment's declining prospects within the industry that invite consideration of nonprofit end game options and the available strategies for maximizing the value of the public's nonprofit equity.

End game strategic options have been characterized as including divestment, harvest, leadership or niche, which can be pursued individually or sequentially *(Kathyrn Rudie Harrigan)*. In theory, the selection of a strategy by nonprofit providers should be guided by expectations concerning the pace and extent of the decline and each provider's competitive position and the resulting impact on the nonprofit's pursuit of its mission. To illustrate, if expectations assumed nonprofit competitors would exit their marketplaces at approximately the pace that investor-owned competitors added market share, then any erosion of the profitability of remaining providers would be modest and the market environment in decline might be hospitable.

Unfortunately, the competitive environment during the interval of nonprofit eclipse can be expected to be one in which both nonprofits and investor-owned providers experience fierce price competition and years of shrinking profitability. This expectation supposes that during the initial phase of decline, nonprofit executives will be guided by assumptions that demand for nonprofit services will revitalize or level off. As below-trend performance becomes chronic, the emotional attachment of senior management to the organization and its mission, together with growing apprehension about key executives' own futures, will constitute a formidable barrier to exit.

While divestment will be the rational strategy for most nonprofits, it will be the road less traveled for many, for reasons attributable to the high exit barriers faced by nonprofits and the impediments to overcoming them discussed previously. Instead, many nonprofit providers will respond by cutting prices, forcing competitors - both nonprofit and investor-owned - to do likewise *(Kathyrn Rudie Harrigan)*. The resulting pressure on margins will tend to make a harvest strategy untenable. Leadership is a realistic strategy for only the largest, best capitalized and best managed nonprofits, and then only on a regional basis given the capital capacity required of national consolidators. A niche strategy can expect fierce competition as industry providers explore every alternative to maintain market share or expand margins.

Most likely, each of the available end game strategies will fall far short of the goal of advancing a nonprofit's charitable mission, while also failing

to maximize the value of charitable assets. Certainly, nonprofit executives have little interest in divestment to maximize the value of the public's equity at the price of their jobs, and instead, as research has shown, managers will maximize the present value of their stake in the employer *(Bart M. Lambrecht)*. With management's resistance to divestment unchecked as a result of ineffective governance, many weakened nonprofits - and the few with significant financial resources - will commit to remaining in business. Absent the existence of any ownership interest or a market for nonprofit control, this wealth-destroying strategy constitutes the optimal course available for advancing management's private interests, and it can be sustained to its inevitable conclusion: bankruptcy. *(See Exhibit C, page 11)*.

EXHIBIT C: THE KIDSPEACE SAGA

More than a century following its incorporation, Wiley House issued $42 million in tax exempt bonds in November 1989. The financing followed a year in which the nonprofit's annual revenues reached $15 million for the first time. The bonds were issued on a non-rated basis and without an equity contribution, with the long-bond paying 8.75% interest. The primary purpose of the financing was to construct 280 residential beds and 36 inpatient beds on a 225 acre campus in Lehigh County, Pennsylvania. The Official Statement provided to bondholders noted that Wiley House had no plans to enter into any other long-term debt, and included disclosures regarding the absence of any fixed price construction contracts as of the bond issue date, as well as a reference to Wiley House's defined contribution pension plan, which provided for a monthly contribution equal to 12% of each participant's monthly earnings. The Official Statement noted that Wiley House's twenty member board of trustees was responsible for general management of the organization, which it exercised through the employment of a management team whose three senior executives were each social workers by training. A feasibility study indicated that sufficient funds could be generated to meet Wiley House' financial requirements, and forecast a significant drop in the ratio of long-term debt to equity in the years immediately following the bond issue.

Less than two years later Wiley House issued additional bonds in the amount of $26 million – with the long-bond carrying a 9.5% coupon – explaining that a reassessment of needs required an expanded construction program which necessitated the issuance of the Series of 1991 bonds. An updated feasibility study forecast adequate debt service coverage resulting from a sharp increase in Wiley House's net profitability following the completion of the construction program.

Interest rates between 1992 and 1997 offered windows of opportunity to refinance the outstanding high yield bond debt, but KidsPeace (the name adopted by the organization following the opening of its new facilities) was unable to refund its outstanding debt because actual earnings failed to meet expectations set forth in the feasibility studies. Still, during this interval the organization's defined contribution pension plan was replaced by a defined benefit plan; the defined benefit plan provided for benefits payable at normal retirement age, defined as 62.

KidsPeace issued its Series of 1998 bonds in the amount of $75 million to refinance its outstanding bonds, reducing the long bond coupon rate to 6.18%. During the decade that followed, KidsPeace's revenues grew to nearly $170 million but with negligible profitability, and by year end 2007, long-term debt stood at nearly $100 million (including a $20 million unfunded pension liability) while net assets barely exceeded $8 million. Thereafter, efforts to fortify the company's finances led to the admission of clients with increasing levels of acuity, resulting in several serious incidents and a ten-week hold on admissions imposed by the Pennsylvania Department of Welfare. The resulting decline in residential occupancy resulted in a sharp loss in 2009, culminating in a bankruptcy filing in May 2013. The bankruptcy petition listed a liability of $56 million to bondholders and more than $100 million to the Pension Benefit Guaranty Corporation. KidsPeace exited bankruptcy in August 2014.

II. Why Foundations?

The policy justification for legislation providing tax benefits to private foundations is the expectation that by achieving the foundation's charitable mission they advance the public welfare. For many foundation donors, the purpose of their gift is to impact the lives of classes of individuals in need, and the impact of their foundation's grant making is assessed with reference to this goal. Yet private foundations that focus on human services, and who pursue their mission by making grants to public charities, have a legitimate and increasingly urgent interest in the evolution of the nonprofit human services industry itself. Despite having the resources to become well informed and actively engaged in the industry's evolution, foundations have not played a meaningful role in addressing the central challenges facing nonprofits or their declining role in the human services system. While philanthropic innovations alternately christened "venture philanthropy," "social entrepreneurship" or "impact investing" have made their appearance (the names themselves suggesting an awareness that nonprofit performance was ineffectual), each of these strategies has focused on capital access *(Anthony Bugg-Levine)* without attempting to redress structural deficiencies of the nonprofit corporate form. Indeed, each seems to suppose that nonprofit organizations would perform satisfactorily if only sufficient capital and the proper financial incentives were made available. It is long past time to adopt a broader perspective that incorporates recognition of the structural impediments to nonprofit performance, and to hedge the probability that these impediments are insurmountable.

The single most important intervention with respect to nonprofit human services organizations in decline is ***the evolution of a locus of control external to the firm***. This external locus of control must possess the industry expertise needed to assess strategic alternatives, have the capability to augment otherwise available capital, and be incentivized to monitor plan execution. Of the various nonprofit stakeholders in the nonprofit ecosystem – a category that customarily includes employees, payors, donors, consumers, beneficiaries, regulators, creditors, suppliers and the local community - that might be considered for this role, only one can potentially satisfy all of these criteria: private foundations. Foundations stand alone among nonprofits' diffused stakeholders in their potential to undertake the extensive information-gathering and analysis necessary to assess strategic alternatives and to provide additional capital. Further, foundations' independence from management enables foundations to monitor and limit agency costs and to adopt an activist approach in their relationships with investees and potential investees.

Foundations have historically had no interest in active governance of the nonprofits they support, and so have never evolved the skills required to engage in it. Changes in the human services marketplace invite a rethinking of this historic reticence, while creating an opportunity for a new foundation business model built around collaboration. This new business model can be designed to focus on identifying nonprofit strategic and governance failures and intervening for the purpose of reversing policies that dissipate the value of public equity *(Ronald J. Gilson)*.

In essence, foundations alone are positioned to play the role once filled in the private sector by money center and investment banks: the core of a network that maximizes value, monitors performance, and diffuses best corporate practices.

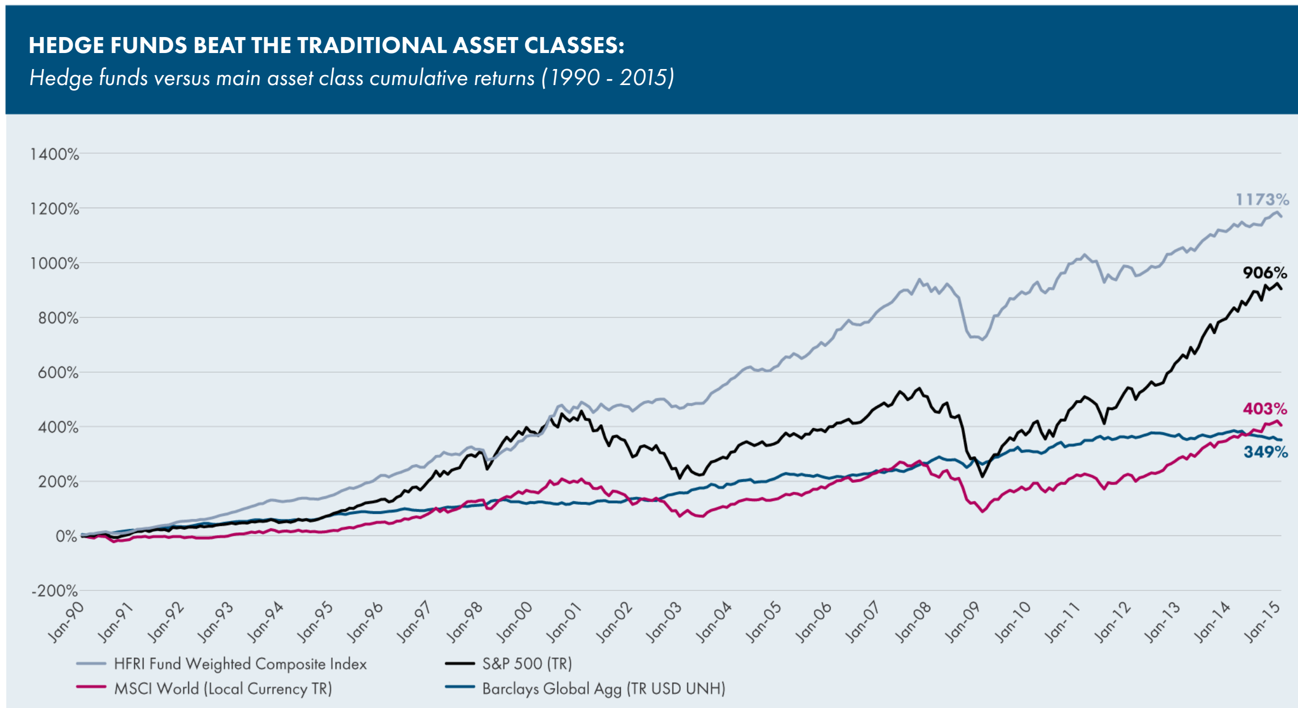
III. Why Activism?

The fiduciary duty of foundation boards to pursue their charitable mission is analogous to that of institutional investors, who have a fiduciary duty to pursue their client's investment objectives. Historically, when institutional investors were dissatisfied with the share price of a portfolio company they simply sold their stock in that company. Alternative courses of action, such as undertaking an effort to influence management to change its course, would have entailed economic and other costs fund managers preferred to avoid. As institutional investors have grown larger, however, fund managers are unable to divest large shareholdings without depressing the price of the security being exited; in other instances, institutional investments are held in index funds and so institutional investors cannot effectively escape the impact of poorly performing shares included in the index. In each of these instances, institutional investors find themselves without alternatives to pressing management – alone or in combination - to take such steps as necessary to increase shareholder value. Today, many large institutional investors have evolved a symbiotic relationship with activist hedge funds, whose actions make it easier for institutional investors to pressure companies behind the scenes *[Page163 Dear Chairman]*. Simply stated, hedge funds and activism create shareholder value. The data on hedge fund and activist fund performance below substantiates their outperformance.

Like other institutional investors, foundation investment managers required generations to become comfortable with the role of activism in the management of their portfolios. Nearly a century ago Rockefeller Foundation counsel Thomas M. Debevoise offered the following advice to the organization's original trustees: "...I think it very important for the Board in these cases to take consistently the position, publicly when necessary, that it is a charitable corporation and as such holds its securities only as an investor; that it is not equipped to direct the activities of a business corporation;....and that its only course when it is displeased with the management of a corporation in which its funds are invested is to dispose of the investments..."[2] Over time, it became apparent that taking the "Wall Street Walk," as Debevoise suggested, effectively ceded future growth and profit potential to the entrenched management teams and boards of underperforming companies, and robbed shareholders of their proper due.

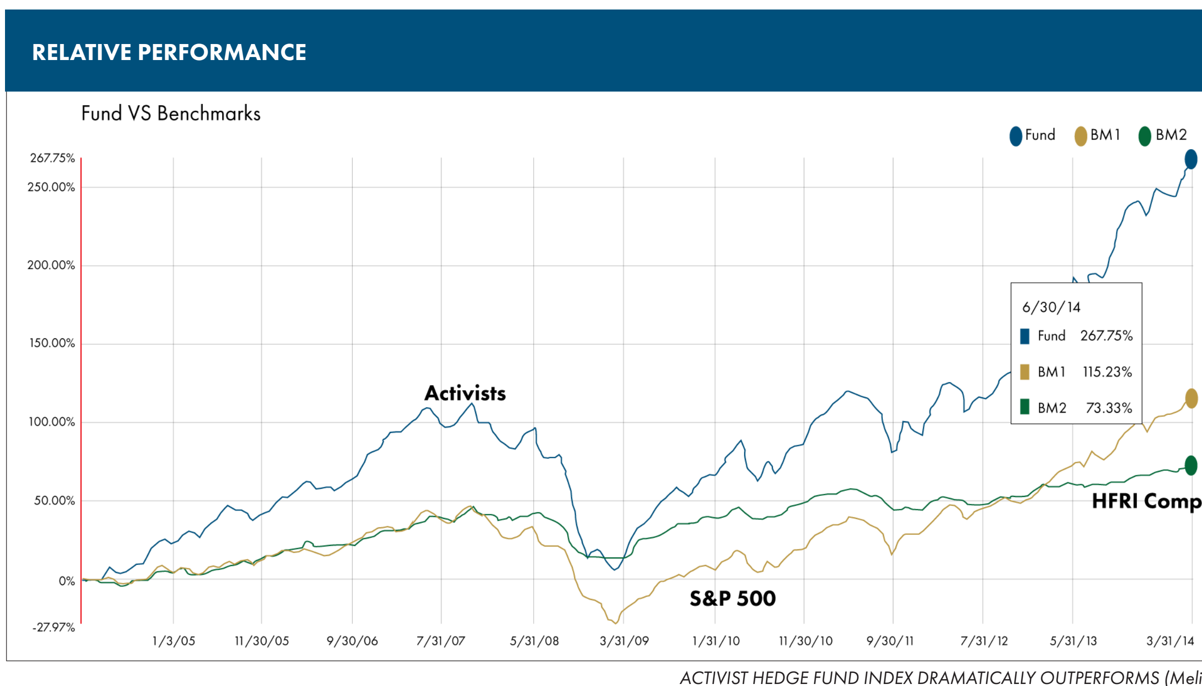
2 Gramm, 12.

The time has come to adopt similar activist approaches to the management of foundations' mission-related pursuits. Indeed, it could be argued that while institutional money managers have limited incentives to monitor equity investments because they keep only a fraction of the portfolio gains, foundation managers have a greater incentive to monitor their own and the public's investments in nonprofits because foundations' grants to nonprofits are permanent and not recoverable through any type of liquidity event *(Black)*.



HEDGE FUNDS BEAT THE TRADITIONAL ASSET CLASSES (1990-2015) (Neil Wilson)

While institutional investors can assess investment performance by reference to returns on invested capital, there is no generally accepted standard by which to assess nonprofit performance in the human services industry. For this reason, we offer the following as the standard by which nonprofit human services organizations should be judged: a nonprofit human services organization should provide the greatest volume of relevant services that can be prudently offered within the limitations of the available resources. We view this standard as consistent with the public interest, as well as the interests of nonprofit beneficiaries, payors, and providers. Further, this standard can be assessed for virtually all providers by reference to readily available data, enabling an activist philanthropic fund to identify providers who underperform relative to their peers, and to assess whether it is necessary to pursue interventions that have proven effective in the private sector.



ACTIVIST HEDGE FUND INDEX DRAMATICALLY OUTPERFORMS (Melin)

In the future, if quality indicators become more discernible and widespread based on the availability of improved technology and data analysis, human services performance metrics will likely reflect both volume of services provided and outcome quality. Such developments would mirror broader trends now occurring in the healthcare sector.

As applied to their philanthropic investments, activism is a strategy by which a foundation, either directly or indirectly (through a special purpose entity), and alone or in collaboration with other foundations, asserts demands for change to targeted nonprofits with the goals of advancing both the foundation's and the nonprofit's missions and increasing the value of the public's nonprofit investments. These demands for change will typically entail revamping some combination of the nonprofit's governance, management, strategies, internal processes and capital allocation decisions.

When activists rose to prominence in the 1980's, these disruptors were coined "corporate raiders," but the growing support for activists from institutional investors has made it possible to reposition activists as defenders of shareholder's rights in the challenge to limit management's self-interested conduct. Since activist funds are independent of management, adequately capitalized, professionally managed and properly incentivized, they are uniquely positioned to reduce the agency costs associated with publicly-owned companies, where - as in nonprofits - ownership and control are separated, and ownership is diffused such that no one shareholder or stakeholder controls a significant proportion of the corporation's total resources.

Of course, not every relevant private foundation's charter provides the flexibility to adopt the role of activist investor, and fewer still would choose it. Yet foundations prepared to deploy activist tactics can have an enormous ***positive systemic impact*** on the human services industry, its nonprofit providers, and most importantly, if indirectly, consumers.

THE HYBRID FUND MODEL We propose that select foundations adopt an activist investor approach to guide their philanthropic engagements with human services nonprofits. More specifically, we advocate the adoption of the multi-strategy hybrid business model, which combines attributes of hedge funds and private equity within the same organization. The allure of the hybrid fund business model for foundations' investments in human services nonprofits is that this vehicle can efficiently address each of the key structural issues thwarting nonprofit value creation and preservation: the inability to access and redeploy capital, ineffective governance and excessive agency costs. Further, the model supports a flexible and efficient investment partnership structure that accommodates foundation capital commitments of varying size and duration.

Hybrid funds are typically established as limited partnerships and capitalized with a substantial pool of unregulated equity that is leveraged and deployed in a variety of trading strategies with the goal of generating atypical returns. The fund's general partners, who invest their own capital in the fund, are professional managers whose compensation is performance based. These professional managers insert themselves into governance, management and strategy of their portfolio companies, which are typically selected because of a perceived gap between current and potential valuation. The hedge fund component of hybrid funds typically does not seek control, but rather pursues alpha (i.e. excess returns uncorrelated with market performance) by extending credit or by identifying investment opportunities - in the case of nonprofits, bonds or bank debt - that are mispriced by the marketplace.

The private equity component of the funds is focused on acquiring control and seeks to create alpha by improving the valuation of individual companies then exiting the investment at the peak of the business cycle. The fundamental differences between hedge funds and private equity pertain to the differing lock-up periods required of fund investors, their differing practices with respect to the reinvestment of the proceeds from the sale of investments, and the timing of the payout of management fees. The allure of merging hedge fund and private equity approaches into a hybrid fund is that doing so effectively combines business and investment-portfolio management strategies *(Felix Barber)*.

A hybrid fund capitalized by foundations (hereafter referred to as Hybrid) would target both financial and social goals, with net returns to limited partners seeking to beat a recognized benchmark such as the U.S. Private Equity Index published by Cambridge Associates. Social goals would include enhancing the public's welfare by improving nonprofit human services resource allocation system-wide and thereby increasing the valuation of the industry's nonprofit participants.

The primary focus of Hybrid's investment strategy would be active management of below investment-grade or distressed tax exempt or taxable revenue bonds or bank debt issued by nonprofit human services organizations. Distressed debt potentially provides investors with the cash flow of a debt security with the appreciation potential of an equity security, and is a particularly useful vehicle for investing in turnarounds because debt has preference over equity in bankruptcy proceedings. Distressed debt investors seek opportunities in which they believe the debt is mispriced and will be revalued – often as a result of the adoption of policies they advocate.

The original issue amount of debt targeted by Hybrid would typically be in the $5 million to $50 million range and would be purchased by Hybrid in the secondary market at a sharp discount to face value, as secondary market investor interest in unrated and distressed debt in these amounts is very limited. Recent historically low interest rates and tight credit spreads, together with the treatment accorded bondholders in the Detroit and Puerto Rico restructurings, are likely to further reduce investor appetite for these credits. A second focus of Hybrid's investment strategy will be the

placement of subordinated short or intermediate term high-yield debt with human services nonprofits whose capital needs are event driven such as acquisitions, interruptions in cash flows resulting from state budget impasses, or "rescue" financings to prevent a Chapter 11 filing.

The dearth of demand for the credits targeted by Hybrid is, per se, a potential source of value creation, but it is not the source of Hybrid 's competitive advantage, which results from Hybrid manager's ability to source investment products satisfying Hybrid's criteria, analyze the business and capital structure of the nonprofit issuers, and uniquely, to introduce changes in provider strategy and operations or to broker - and when necessary, finance - business combinations that enable a restructuring of the nonprofit debtor's balance sheet.

Historically, foundations have deployed capital independently rather than collaboratively, and have tended to diversify their grants amongst a variety of (often small) providers. These practices have discouraged any one foundation from acquiring the expertise necessary to perform the fundamental analysis at the firm level required to identify poor provider performance, analyze its causes, and craft the strategy and tactics required for a successful turnaround. Operating at scale, Hybrid's General Partner can efficiently acquire this expertise through its contractual relationship with its management company. Hybrid's investment approach of making concentrated capital investments in a small number of large providers, overseen by sophisticated industry professionals, reduces the monitoring and coordination expenses related to Hybrid's portfolio of hedge fund and private equity type investments. In essence, Hybrid effectuates the power foundations have always possessed by virtue of their capital resources, but never had the expertise or inclination to exercise *(See Exhibit D, page 19)*.

Hybrid's credit/distressed investment strategy can generate exceptional returns while redressing the following nonprofit provider structural failings:

Capital Access: Hybrid can provide short and intermediate term subordinated capital either directly (through loans) or indirectly (through loan guarantees) to providers for a broad range of purposes including working capital, bridge loans, project loans or acquisition financing.

Ineffective Governance: Adopting an activist role, Hybrid can provide subordinated debt to nonprofit providers conditioned upon adoption of specific changes in provider governance, strategy or policies ranging from appointment of additional trustees nominated by Hybrid, or pursuit of strategic alternatives advocated by Hybrid, to adoption of Hybrid favored policies or practices including changes in senior management or compensation. Alternatively, in instances where the target company has outstanding public or private indebtedness, Hybrid can purchase all or a portion of the debt and exert influence through strict enforcement of the debt covenants, with the ultimate goal of increasing the value of the debt through means such as advanced refunding. Finally, in certain instances, when all else fails, Hybrid can seek to short the nonprofit's outstanding bonds or purchase credit default swaps if and when that derivatives market is revived.

Agency Costs: Leveraging its independence from provider management and the industry expertise of its fund manager, Hybrid is well suited to monitor and constrain its portfolio management's pursuit of their private interests, and to introduce compensation arrangements that align management incentives with the nonprofit's mission-driven goals. Efforts to achieve this outcome commence with non-confrontational meetings with the nonprofit's trustees and chief executive, and can proceed with more aggressive tactics if necessary.

Hybrid's private equity component can also be utilized to address the following nonprofit provider challenges:

Chronic Underperformance: At the heart of private equity value creation is the strategy of acquiring underperforming businesses, aggressively executing a performance improvement program, and then selling the investment. The strategy involves the introduction of value creation initiatives focused on increasing revenue, improving incentives and

EXHIBIT D: BLUE MERIDIAN PARTNERS

Blue Meridian Partners ("Meridian") is a growth capital aggregation collaboration ("GCAP") founded in 2016 for the purpose of investing at least $1 billion in high-performance nonprofits impacting children and youth, and thereby the broader system of care. As of May 2016, Meridian's donors, which include general partners who have committed at least $50 million, and limited partners who have committed at least $10 million, have raised $750 million. Each general partner casts one vote on the Blue Meridian Partners board; limited partners do not have a vote.

Meridian's investment approach incorporates four major components: business planning, growth capital, performance tracking and strategic counsel. All of Meridian's investments are structured so that payout depends on a grantee's progress toward goals that are the terms of its investment. This progress is tracked by mutually agreed-upon performance measures that reflect the goals set during business planning.

Similarities and differences between the Meridian approach and the hybrid fund approach ("Hybrid") are summarized below:

- *Both approaches are structured as limited partnerships whose investors are philanthropies, albeit only Hybrid seeks to provide an economic return to the partners;*
- *Meridian provides capital to nonprofits it deems high-performing, while Hybrid provides capital to large nonprofits deemed underperforming;*
- *While Meridian characterizes its capital transfers to nonprofit recipients as "investments," there appears to be no basis for a claim by Meridian to recover all or any portion of the capital transferred to a nonprofit in the event that performance fails to meet targeted outcomes. Hybrid provides capital pursuant to a loan agreement that provides for consideration including the return of invested capital together with the interest thereon, and failing that, for control of the nonprofit;*
- *Business planning, growth capital and strategic counsel are incorporated into both the Meridian and Hybrid approaches, albeit these elements of the Meridian approach are incorporated because of their benefit to the nonprofit, whereas the primary beneficiary of these elements in the hybrid approach is the Hybrid fund, which requires improved nonprofit financial performance to satisfy Hybrid's return expectations;*
- *Meridian seeks to achieve its goals by transferring permanent new capital to enable nonprofits to grow evidence-based practices to scale, while Hybrid seeks to introduce strategic and operational changes – often through changes in corporate control – intended to better utilize existing nonprofit capital;*
- *GCAP's have eschewed complex economic models for sustainability in favor of a simple proposition: sustainability improves as the share of an organization's budget coming from reliable-renewable funding sources increases. Hybrid, on the other hand, measures sustainability by reference to compound annual growth rates of revenues and unrestricted net assets relative to peers.*

governance, replacing management and reducing costs. The process, which can be imitated by Hybrid, frequently includes the execution of one or more add-on transactions, and would conclude with Hybrid selling its equity in an asset transaction, typically via an auction process. This process advances a critical component in maximizing the value of public assets: a market for nonprofit control.

Capital Misallocation: A nonprofit's capital structure reflects management's risk preferences, which frequently vary significantly from one peer provider to another, and from the optimal capital structure appropriate to the achievement of the nonprofit's mission. The variations in risk preference are due to the fact that in the nonprofit world, as in the private sector, management teams sometimes eschew risk because executives' incomes are dependent upon the financial stability of their employer, and so management opts to maximize the security of its income stream. Further, two well-documented behavioral biases, loss aversion (the phenomenon in which managers fear loss more than they value equivalent gains) and narrow framing (the phenomenon in which people weigh risks as a single outcome rather than as one of a larger number of outcomes in a portfolio) are also risk-aversion factors evidenced by managers *(Tim Koller)*.

Capital misallocations attributable to risk aversion are apparent in many large, well-capitalized human services nonprofits, and are characterized by modest ratios of debt to equity and substantial unrestricted investments. This observation regarding human services nonprofits is supported by research involving the capital structure of acute care hospitals concluding that nonprofit hospitals issue significantly less debt than their investor-owned peers *(Jason S. Turner)*.

In other instances, management assumes imprudently high levels of risk, either because none of the nonprofit executives' personal capital is being placed at risk or because executive compensation in human services organizations tends to be correlated directly with annual revenues. Typically, this situation presents itself in the form of rapidly growing nonprofits with high ratios of annual revenues to net assets, high debt to equity ratios, and current ratios of less than 1.0 times. These situations sometimes result from uneconomic business combinations, which can be used by management as a defensive tactic to prevent their nonprofit from becoming a target.

Faced with entrenched governance and management pursuing self-interested goals, Hybrid can pursue control of nonprofit targets, an alternative approach commonly associated with private equity. In fact, control strategies can be employed to place Hybrid at the center of power in a network of human services providers. The benefit of this approach is that it joins formerly independent nonprofit operations with a source of vast, flexible capital. Private equity firms exercise operational control over portfolio companies through their representation on the companies' boards of directors and through selection and termination of corporate officers.

In instances where the acquired nonprofits offer similar services, the initial acquisition might thereafter serve as the platform investment of a roll-up strategy; in instances where the acquired nonprofits offer diverse services (e.g. when behavioral health, child welfare and developmental disabilities organizations are combined), a parent-subsidiary structure will be the better course. The parent-subsidiary structure might also be preferred when certain of the acquired nonprofits have excess capital while others are undercapitalized. In the latter instances, the parent-subsidiary structure effectively enables capital to be transferred between subsidiaries, either via direct cash transfers or through obligated group financings, with the ultimate goal of increasing the valuation multiple applied to the consolidated entity and thereby maximizing the return on invested capital at exit. The parent-subsidiary structure also invites the establishment of a management services entity, which may be for-profit, thereby enabling Hybrid to provide operating company executives with opportunities to personally invest in their employer as a means to better align owner and management interests and reduce agency costs.

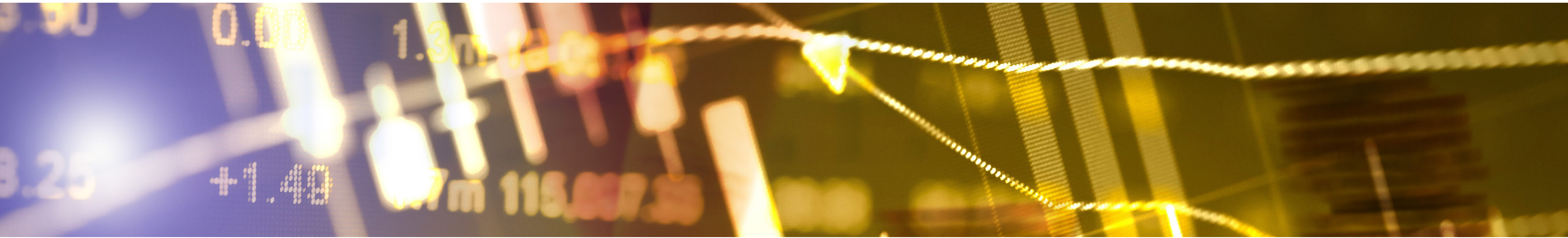
Governance: Many nonprofits have demonstrated through their strategic choices, compensation practices, inaccurate reporting, lack

of transparency, or trustee actions or inaction that they require new or strengthened governance, management or monitoring processes to advance their charitable missions, inviting Hybrid to pursue a change of control strategy.

Whether Hybrid pursues ***positive systemic change*** through a monitoring or control strategy, it can be anticipated that its capital will be focused on a small number of larger (by revenues) nonprofit targets, which in many instances may already be among the human services industry's best capitalized organizations. This focus on larger providers advances Hybrid's aspiration to achieve ***systemic impact*** with its targeted investments because a small number of investments directly impacts substantial industry revenues, and because Hybrid's ability to influence the conduct of larger providers potentially impacts indirectly many other nonprofit providers.

In its private equity formulation, Hybrid presents nonprofit human services organizations with a new avenue for acquiring capital, and with it, a change in traditional nonprofit approaches to governance. This relationship – capital markets innovation altering governance techniques – is consistent with the historical pattern observed in commerce more broadly, albeit not quickly or without friction, because change negatively impacts those favored by the existing order. Over time, it is probable that best practice governance codes for nonprofits, which are always based on capital markets arrangements as they have been rather than how they currently are, will be adjusted to accommodate Hybrid and its imitators in order to allow for practices such as compensating professional nonprofit trustees *(J. M. Ronald J. Gilson)*.

IV. Organizing & Financing An Activist Fund



As monitoring is to serve as the bedrock of a ***systemic impact strategy***, it is best undertaken by multiple foundations in collaboration through a separate legal entity. Monitoring is the preferred approach because monitoring is much easier than managing, costs less, and Hybrid's structure offers the flexibility to transition to control-focused approaches at a later date when control is the best path to value creation.

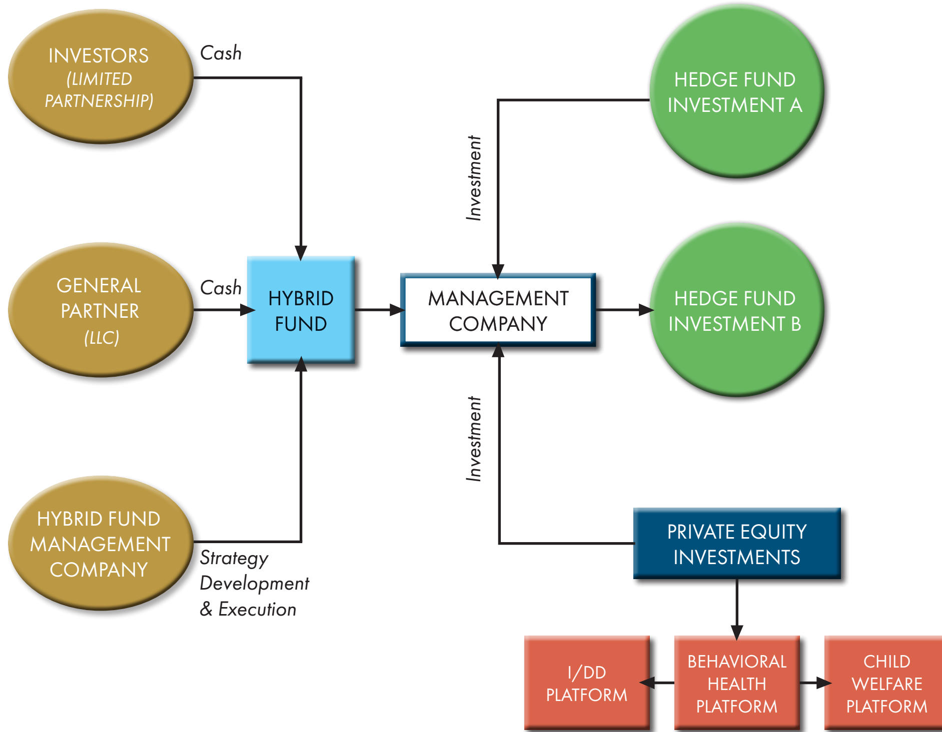
Similar to other activist hybrid funds, Hybrid would be formed as a limited partnership, and managed by a general partner structured as a limited liability company ("GP"). Limited partners have limited liability but no role in Hybrid management. The GP typically contracts with a management company, which is also structured as a limited liability company, to design and execute Hybrid's investment strategy. This structure, which is not without precedent *(see Exhibit E, page 23)*, provides the advantage of limited liability for both the investors and Hybrid's managers, along with the benefit of pass-through taxation.

A controlling interest in the GP, and all limited partnership interests of Hybrid would be held by foundations[3] qualifying as accredited investors and prepared to subscribe to specified levels of investment in Hybrid. A Private Placement Memorandum ("PPM") would be provided to all of Hybrid's investors describing Hybrid's investment strategies and practices, the manager's professional background and its principal owners, Hybrid's structure and business practices, and risks associated with investing in Hybrid. Additionally, the PPM outlines pertinent provisions of the limited partnership agreement including Hybrid's withdrawal and transfer restrictions, management fees, valuation procedures and profit and loss allocations, as well as information about investor qualification and suitability standards and subscription procedures. Disclosure pertaining to lock-up periods, redemption rights and procedures, Hybrid 's service providers (including legal counsel, prime brokerage firm, and fund administrator) and potential conflicts of interests may also be discussed.

To illustrate how Hybrid would secure capital and make investments, let us suppose that equity in the general partner limited liability company is owned by four foundations, each of which invested $25 million for their general partnership interest. Limited partners numbered ten initially, each of whom invested $5 million for their limited partnership interest. With its initial capitalization aggregating $150 million, Hybrid would enter into short-term financing

3 Tax-exempt U.S. investors are generally exempt from paying federal income tax, other than with respect to debt-financed income and business income (as opposed to investment or trading income). Such income is referred to as "unrelated business taxable income," or "UBTI." A tax-exempt U.S. investor can generally avoid UBTI by investing through a "blocker" – a corporate entity where the character of the income (such as UBTI) does not "flow through" to the investor as it does with U.S. pass-through entities. Rather, the corporate entity is the tax payer. Because corporations in the U.S. are taxed up to 35%, tax-exempt U.S. investors prefer to invest in a corporation in a non-U.S. jurisdiction where there is no entity-level taxation, which allows them to maintain their tax-exempt status while protecting them from incurring UBTI (Managed Funds Association and Schulte Roth & Zabel LLP).

EXHIBIT E: HYBRID ORGANIZATION
Hybrid Fund Organization Structure



arrangements with a prime broker targeting leverage of 1.2 times, which is modest leverage for a hedge fund, but consistent with Hybrid's distressed debt investment focus.

Hybrid would proceed to invest capital for various durations in target companies, in some instances by providing leveraged loans or purchasing new high yield bonds, in other instances by purchasing outstanding bonds in the public market or notes from lenders at a discount, and in still other instances, by deploying capital with the intent of securing corporate control of one or more nonprofits and exiting thereafter at a premium price.

TARGET SELECTION AND ANALYSIS

How does Hybrid select target companies among various nonprofit prospects given that outcomes achieved by human services organizations to date are notoriously difficult to define and quantify?

All activist funds must develop screening criteria through which they will identify target companies. Hedge funds resemble value investors in that their focus is non-control investments in targets that exhibit lower market value relative to book value, the potential for improved returns on assets, lower payouts to shareholders, and more takeover defenses, than comparable non-targeted firms *(W. J. Alon Brav)*. Private equity firms typically target control investments in private firms that have large cash balances and lagging shareholder returns attributable to anemic revenue growth and a growing gap in margins relative to peers *(Joseph Cyriac)*. The key metric in a public company transaction is the deal's impact on earnings per share.

Activist funds screening for nonprofit targets must begin with identifying peer groupings within human services industry segments. Searches of the Guidestar database utilizing filters including NTEE codes and various accounting data are useful in this regard, and for issuers of tax exempt bonds, this data can be augmented with information available through the MSRB's Electronic Municipal Market Access website (commonly known as EMMA). While accountability for achieving nonprofits' missions can theoretically be assessed across multiple dimensions, it is only the failure to properly manage financial resources that can be conveniently measured by reference to peer performance data. We suggest that financial analysis of human services nonprofits should focus on the compound annual growth rates ("CAGR's") of revenues and unrestricted net assets of peer organizations with annual revenues of $100 million or more, ideally over the most recent five year interval. Our view is that these measures shed light on the degree to which a nonprofit is progressing in its pursuit of the standard by which nonprofit human services organizations should be judged: delivering the highest volume of pertinent services that can be prudently offered within the limitations of the available resources. In this construct, revenues serve as

a proxy for the volume of services delivered and unrestricted net assets offer a measure of existing nonprofit resources.

This analytical framework enables the classification of exceptional performance *(see Exhibit F)*, and often permits the evolution of a hypothesis to explain performance differences. For poor performers, this hypothesis might point to issues such as scale, competitive strategy, capital misallocation, or poor governance as the focal point of subsequent scrutiny. Ultimately, the goal of this assessment is to group potential target companies into categories as presented below; such classification constitutes an initial step in developing a business improvement plan that includes the specific changes the activist wants management to implement.

Companies in **Quadrant I** have underperformed relative to peers over the five year period with respect to both growth and margins, inviting a preliminary conclusion that a change of management is necessary, and a change in control is desirable, ideally to a provider whose performance placed it in Quadrants III or IV.

EXHIBIT F: THE CLASSIFICATION OF EXCEPTIONAL PERFORMANCE

Companies in **Quadrant II** are growing revenues satisfactorily but without earning the margins necessary for sustainable growth. This circumstance may have its origins in a misguided corporate strategy, such as when management has pursued product or geographic diversification without appreciation for the constraints associated with the organization's capitalization. The resulting excessive financial risks may be deemed tolerable by management if executive compensation is closely tied to revenue growth. Nonprofit "conglomerates" should be pressed to divest business units being conducted in markets where the provider is without identifiable competitive advantages.

In other instances, a highly effective nonprofit with a single service line may simply be attempting to satisfy growing demand under circumstances in which inadequate capital access is preventing investments in the infrastructure required to benefit from scale economies. Rapidly growing nonprofits in this situation can potentially benefit from a relationship with a supplier of flexible capital like Hybrid. Companies in Quadrant II require further analysis to determine the interventions necessary to transform Quadrant II providers into Quadrant IV providers.

Companies in **Quadrant III** are achieving sustainable margins but without adequate revenue growth. This circumstance may be attributable to the organization generating investment income in excess of current requirements as a consequence of being over-capitalized. This situation presents the greatest risk of excess agency costs, and companies in Quadrant III should be pressed to pursue aggressive growth strategies focused on acquisitions.

Companies in **Quadrant IV** have outperformed relative to peers over the five year period, inviting a preliminary conclusion that a commitment of additional capital by Hybrid, perhaps in the form of loan guarantees for an acquisition credit facility, is appropriate.

Analytical processes such as those summarized above are only one means of identifying Hybrid targets; other targets may be identified based on various events, such as bankruptcy filings or changes in the executive suite. One frequent situation involves targets identified in connection with the sale of a business or assets, under less than optimal terms, often in an effort to advance management interests. In such instances, Hybrid can pursue various courses of action to intervene, including the submission of a competing offer, or broker offers from competing suitors. In other instances, nonprofits pursue acquisitions or affiliations that should be abandoned because they divert capital from alternative uses, or decline business combinations that should be explored, in each instance for the purpose of advancing management interests.

Tips are another means by which targets are identified *(Javier Castellanos)*. Activist funds will receive tips from third parties (including institutional investors and corporate executives) with a variety of motivations. In every instance, Hybrid needs to undertake its own research to determine the quality of the information presented – and in instances where the informant proves reliable, Hybrid might formalize the relationship by providing contingent finder's fees.

Finally, targets can be identified by reference to operating characteristics that suggest that governance is either a captive of management, inept, or fraudulent. Excessive management compensation is the most common manifestation of this circumstance, but others include suggestions of ineffective governance. Two illustrations include the presence of outsourced management services when the owner of the contractor is the founder or a trustee of the nonprofit, or the presence of an active but underfunded defined benefit pension plan. The absence of trustee term limits can also be an indication of excessive agency costs.

Following target identification by any of these means, Hybrid must undertake a disciplined analysis to determine whether clearly defined objectives are achievable – and at what cost. The analysis will proceed like any investment analysis, with a forecast of alternative balance sheets and cash flow statements in order to determine the expected returns relative to the investments of capital and human resources required from Hybrid. The final products of the analysis will include a detailed and thoughtful plan for addressing the target's strategic and operational challenges, and a strategy for executing the deal.

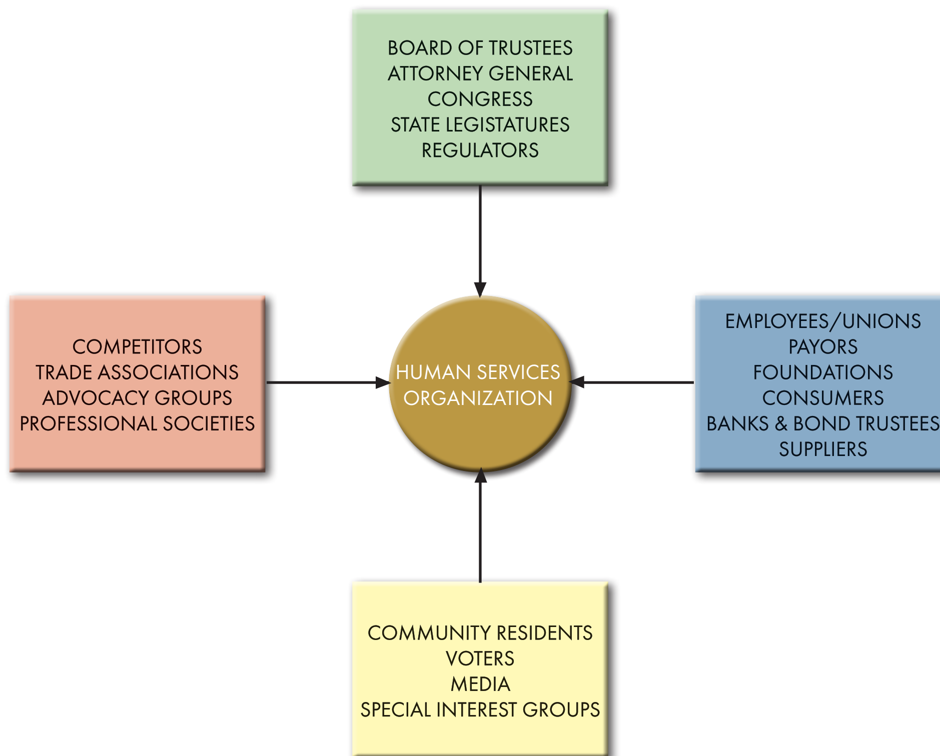
V. Activist Fund Tactics

Nonprofit activist tactics proceed from the premise that it is appropriate and necessary to expect nonprofit organizations entrusted with public capital to demonstrate progress towards achieving their stated mission over time, to a degree approximating or exceeding the performance of its peers. This implies that corporate control of nonprofits failing to meet this expectation should either be transferred to more capable management or redeployed by a nonprofit whose performance has met or exceeded performance expectations.

Typically, hedge fund activism is a multi-step process that begins quietly by investing capital in the selected target, and Hybrid will do likewise, albeit with options limited to purchasing outstanding bond or bank notes. Alternately, the process can begin with an approach to target governance and management seeking a meeting to discuss the activist's business improvement plan. Efforts to commence informal discussions and negotiations with target company executives range from a simple phone call to more formal communications transmitting the business improvement plan along with indications of support for the plan from other nonprofit stakeholders. In the human services industry the relevant stakeholders are summarized in the chart in Exhibit G*(Rawlins)* *(see Exhibit G, page 27)*. Prioritizing and nurturing these stakeholder relationships can be critical to the success of the activist's campaign, as stakeholder alliances enhance or create attributes such as legitimacy, power and urgency key to gaining the target company's attention and achieving the activist's goals.

In most instances, voice will be both the most effective and least costly mechanism to achieve improved performance in the short and intermediate term. Institutional voice refers to the process by which multiple stakeholders endeavor to induce changes in corporate behavior informally and through collaborative action. Voice stands in contrast to stakeholders' traditional preference of disengagement in dealing with failing nonprofit organizations, yet is not directed at obtaining control, usually because control is perceived as infeasible, undesirable or too costly. By sending letters or meeting with senior executives or board members, stakeholders can express their support for the adoption of changes advocated by the activist.

EXHIBIT G: RELEVANT STAKEHOLDERS IN THE HUMAN SERVICES INDUSTRY



MODIFIED FROM J GRUNIG & T. HUNT, MANAGING PUBLIC RELATIONS, HOLT, RHEINHART & WATSON, 1984, P.141

It is estimated that commercial hedge funds initially adopt a non-confrontational approach in about three-quarters of their campaigns, but that less than a third end collaboratively *(Joseph Cyriac)*. Activist campaigns focused on changes to governance, by-laws or management tend to become hostile, whereas campaigns focused on strategy shifts are more likely to remain collaborative. Given the novelty of nonprofit activism, it is likely the experience of nonprofit activists will be similar. Indeed, given that nonprofit trustees and officers have operated historically without any external locus of control, it is likely that targets will instinctively react with indifference or defiance to the activist's initial overture. For this reason, an activist fund must be prepared with an activism plan that incorporates a range of approaches intended to escalate pressure on the target over time, consistent with the expected benefits to be obtained.

Tactically, voice can escalate to include actions such as publicly skewering CEOs and trustees for sustained poor performance, together with references to self-dealing and nepotism when supported by facts, and amplified through the entire range of a modern media ever inclined towards topics involving crisis and conflict. The resulting pressure on the company often leads the target to take action to end the adverse coverage. As always, timing matters in the selection of the specific tactics to be deployed, and the structure of executive compensation and career concerns often make executives sensitive to short-term questions regarding management performance closer to the nonprofit's year-end.

Of course, even when informal action is effective, the ability to directly or indirectly influence formal board actions is critical, since management commitment to timely execution of policies they have previously rejected (or failed to recognize) can be relied upon only in instances in which managers understand that they will be removed otherwise. Activists' ability to influence formal board action may be achieved by offering various "carrots" such as agreeing to make future capital investments contingent upon the achievement of certain performance milestones or through threats ("sticks") of further escalation of hostile tactics.

One means of advancing the adoption of its business improvement plan is for the activist to propose nominees for election to the target company board. These fund-sponsored and paid trustees – who could be employees or contractors of Hybrid's management company – can effectively monitor the nonprofit's strategies and execution without the allegiance to corporate officers that can compromise the effectiveness of volunteer trustees. Selected for their role by virtue of their experience and training, Hybrid-sponsored trustees can be expected to educate other trustees and officers

regarding their duties of care and loyalty, and focus board attention on questions associated with company strategy, performance, and capital allocation.   Additionally, nonprofit directors are in a position to both advocate value-creating strategies and decisions and prevent strategies and decisions that destroy value, while monitoring management's self-interested behaviors. Lastly, nonprofit trustees have a rare and valuable attribute under nonprofit law: standing to sue their nonprofit for breach of fiduciary responsibilities *(Black)*.

VI. Risks Of The Hybrid Fund Approach

The hybrid fund approach outlined here can create ***positive systemic impact*** by improving provider performance, advancing industry consolidation, increasing the valuation of public assets, and enhancing the alignment between nonprofit service providers and private foundations. The question arises, however, whether these benefits might be counterbalanced by any adverse impacts related to increased foundation influence over the nonprofit human services system. Concentrated power of this sort evokes images of greedy capitalists running roughshod over the competing interests of other stakeholders, much as commercial banks have been portrayed at the inner circle of a network of elites controlling public companies in the early 20th century. Of course, the absence of a public equity market eliminates the means by which powerful interests have benefited in public securities markets as foundations have no ability or incentive to trade on inside information or divert nonprofit income to foundation coffers.

It is possible that foundations, through their control of capital, can exert broad leverage over nonprofit human services organizations to the detriment of other stakeholders, though in reality, diffused stakeholder involvement in nonprofits has had the peculiar effect of disempowering stakeholders, much as shareholders have been disenfranchised by virtue of the growth of large corporations in the private sector *(Gramm)*. As a practical matter, nonprofit corporations are routinely as disconnected from their stakeholders as corporations are from shareholders, which is the very reason that an external locus of control such as Hybrid is needed.

Introducing Hybrid into the relationship between foundations and the nonprofits they support clearly does entail the creation of a double agency relationship (i.e. between the foundation and Hybrid and between Hybrid and the nonprofit). It can possibly be argued that the solution to a structural failure may not entail multiplying agency relationships *(Ronald J. Gilson)*.

Obviously, an assessment of the risk that foundations will abuse their power must be weighed against the risks of management abuse under the existing system *(Black)*. Yet even in the absence of any abuse of power, the risks associated with the hybrid model must incorporate the reality that this solution minimizes or ignores the fact that different nonprofit stakeholders may have conflicting interests. Additionally, the hybrid model assumes Hybrid executives

are competent and have the industry expertise and organizational competence to monitor management, but this is not assured, and in any event, professionals make mistakes.

Much like banks operating in economies without mature securities markets, foundations can exercise a significant influence over the conduct of nonprofit providers and the system of care without de jure or de facto control. Indeed, because nonprofit capital is scarce and can greatly magnify a nonprofit's mission-related impact, and because the legal and regulatory restraints on foundations' conduct are de minimis relative to those imposed upon other institutional investors, foundations can exert a measure of influence over their nonprofit targets that banks in the commercial world would envy.

About The Authors

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Kevin is the President of Angler West Consultants, Inc., an advisory firm focused exclusively on mergers and acquisitions of human services organizations. Clients of the firm have included public, private and nonprofit corporations. Founded in 1996, Angler West has been involved in more transactions involving human services organizations than any other broker over the past two decades.

Prior to founding Angler West, Kevin had more than twenty-five years of experience serving as a senior executive of various nonprofit health and human services organizations. This experience included positions with providers of behavioral healthcare, substance abuse treatment and developmental disabilities programs.

Kevin has published articles on topics including business combinations, financial restructuring, valuation, and governance of nonprofit organizations and has presented at conferences on these and other topics.

Anne S. Morse
Managing Partner, Aronwold Partners, LLC

Anne's experience in the healthcare industry covers over 25 years. During her career, she has structured and underwritten financial transactions and credit support products for a broad spectrum of healthcare systems, senior living communities and human services organizations. In addition to her Aronwold Partners initiatives, Anne became affiliated with Melio & Company in 2013 as a Managing Director and financial advisor. Anne's current client advisory engagements principally focus on financial and capital markets matters involving capital structure, public and private market capital access, M&A related issues and enterprise risk management.

In the past, Anne also served as a Managing Director in Janney Montgomery Scott's Municipal Capital Markets Group, where she concentrated on building a healthcare practice across the firm's core footprint. Prior to joining Janney in 2010, Anne was a senior member of Ambac Assurance Corporation's healthcare underwriting team. Post credit crisis, she managed numerous remediation and restructuring efforts involving both Ambac-insured debt transactions and Ambac's insured derivatives portfolio. Before Ambac, Anne served as a Vice President at both Lehman Brothers and, earlier in her career, at Legg Mason. At each of these firms, she assumed responsibility for business expansion as well as financial analytics, credit assessment, transaction structuring and deal execution within the healthcare sector.

Anne began her career in operations and business development at Harvard Community Health Plan and Universal Health Services, Inc. This direct industry experience enhances her extensive capital markets background, resulting in a unique professional profile and perspective.

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