Many students returning to campus this weekend will find America’s next financial crisis right in their classroom. Are bankruptcies looming?

The Baylor College of Medicine was founded 109 years ago, and remains a Texas institution: one of the world’s biomedical centers and one of only 10 standalone medical schools left in the country. It’s also looking for a financial bailout.

Not from the U.S. government, which doesn’t seem inclined toward direct cash infusions past the largesse already directed at Wall Street and Detroit. Rather, it’s negotiating with Rice University, which has one of the largest endowments in America, about merging itself into the Houston-based school, which should give Baylor College of Medicine a financial cushion it doesn’t have right now.

There’s a trend here. Last year, New York University took over Brooklyn-based Polytechnic University, which gave Poly access to NYU’s considerable resources, and gave NYU a base in engineering, not to mention a good deal of prime real estate. And next year, Vermont’s Middlebury College will subsume the Monterey Institute of International Studies, a graduate school based in California that specializes in linguistics—and was recently $24 million in debt.

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Mergers, takeovers and, yes, forthcoming bankruptcies and closures. Hundreds of financial institutions became reliant on the outsize returns of their endowments in recent years to meet their operating budgets. And now that those performances have gone into reverse, at the same time other sources of revenue have slowed, many colleges and universities are facing the consequences. A shakeout is afoot.

“There’s an oversupply of colleges in the marketplace and there are a number of institutions that since the ’80s and ’90s are just barely sustaining themselves,” says Sean Gallagher, senior analyst at Eduventures, a higher-education research and consulting firm based in Boston. “The fear is that this environment will push these schools over the edge.”

The average university has, at best, four revenue streams: tuition, income from its endowment, grants—usually in the form of government research funding—and donations. All four of those are under strain. Besides the market reckoning, which has slashed most endowments by 25 percent to 35 percent, the tightened credit market has added pressure on families’ ability and willingness to pay the hefty price tag for college. Many schools are also experiencing a decrease in state and federal funding, and difficulty raising money from financially stretched alumni.

Even the wealthiest universities in the country have put in place cost-saving measures like hiring and salary freezes.
More and more are delaying construction projects—Boston University has a moratorium on new building projects; selling assets—trustees at Brandeis have authorized the college to sell a limited number of pieces in its art collection; and axing sports teams—the University of Vermont said it would scrap its varsity baseball and softball teams as part of a $10.8 million budget cut for the next fiscal year.

Christopher Cowen, a managing partner at Prager, Sealy & Co. LLC, the boutique investment-banking firm that specializes in higher-education finance, predicts that M&A—a term almost never used in the rarified world of academia—will also become more common. “There’s been very little merger activity, but we’ll see some that are forced into considering a variety of options,” he says.

Of course, mergers in higher education, as in other industries, only happen when there is an obvious asset at stake. The weak institutions must have some plot of land, some important building, or some program that the stronger institution wants. And because a merger requires one institution to take on another’s debt, there are very few schools in this economy that are in a solid enough position to do that.

Which is why private-equity groups are getting into the mix. Earlier this year, an education investment group bought Crichton College, a heavily indebted private Christian school based in Tennessee. In 2007, Heald College, a financially strapped career school in San Francisco, was sold to a venture company and converted into a for-profit institution.

But other colleges won’t be so lucky; they will be forced to cut programs, declare bankruptcy, or close. Presidents at public universities who are dealing with dwindling state appropriations are already contemplating major reorganizations that could eliminate academic departments. “These are very tough times,” says Selma Botman, who took over as president of the University of Southern Maine last July. “We don’t know where the bottom is.” USM slashed $2.7 million from its budget this year by cutting travel funds, reducing allotments for technology development and library acquisitions, and shutting down the university’s child-care centers. The school is projecting a $4.3 million deficit in the coming fiscal year. Botman is even pitching in by teaching a seminar on Egypt for 15 students out of her home.

“Our problems are cumulative now because this is multiple years of cutting the budgets,” she says. “There are so many pressures and people are concerned—about the college, and about their jobs. Higher education is about people. We don't make widgets so it’s particularly hard.” Like many aspects of society, the debt in higher education is largely their own doing. In recent years, colleges have been in an arms race to attract students by putting up shiny new dorms and state-of-the-art fitness centers. Schools borrowed heavily to build these facilities, planning to finance these ambitious projects through enrollment. Now, parents can’t afford to pay, the value of those assets has plunged, and colleges risk being in violation of covenants in their bonds and bank loans. “It puts them in a precarious position if the bank calls the loans,” says John Griswold, executive director of the Commonfund Institute, which studies university endowments.

Such issues in academia are no longer academic. Emmanuel College in Boston recently warned it may not meet the liquidity covenant required for its fixed-rate bonds if the stock market continues to decline and Central College in Iowa is also on the verge of violating debt covenants, according to Moody’s, the ratings agency.

The private schools most vulnerable to bankruptcy: expensive, middle-tier colleges that lack a strong reputation, and aren’t particularly selective. Antioch College, a liberal-arts institution based in Ohio, closed last summer after years of declining enrollment and budget shortfalls.

“It takes a lot to push a college over the cliff—most have some endowment they can eat away at for a while,” says Sharon Oster, dean of the Yale School of Management, and an expert in nonprofit strategy. “But then, colleges do go under. Look at Antioch.”

Another pressure on the middle tier: larger classes at brand-name schools—Amherst College, for instance, is expanding its student body by 25 students per entering class—as it seeks to bring in more money from tuition. “There’s a trickle-down effect,” says Cowen at Prager Sealy. “If the Harvards and the Penns of the world take in 20
more students, that's 20 that don't go to Emory or Vanderbilt [and on and on down the food chain] until public education looks more attractive."

The dynamics of the market have changed, as well. Colleges and universities have recently enjoyed a swell of applications from the giant generation of baby boomer children, but projections show that the annual number of high-school graduates in the U.S. is at its peak, which will hurt enrollment. Colleges also benefited from a robust housing and stock market, which helped parents afford a four-year degree. As the bubble has burst on the rest of America, higher education can't prove immune.

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