

A New Legal Structure for Social Enterprise in New Zealand

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Exposure Draft

Executive Summary

Legal structures currently available to New Zealand social enterprises are essentially limited to for-profit and non-profit categories. Social enterprises operate via a 'profit-for-purpose model', so organisations face challenges when choosing a particular legal structure. The choice has implications for legal activity, access to funding, and governance obligations. These challenges are set out in detail in this paper.

There are existing ways to creatively address these challenges, including altering company constitutions, or using multiple structures. However, these solutions do not address the fundamental issue that social enterprise currently lacks a recognised and unique identity, which has consequences for the overall sector and impedes access to both public support and investment. Furthermore, the creative solutions are expensive and inaccessible for many social enterprises, which have limited resources and access to legal support.

Overseas, new hybrid legal structures have been created, which are uniquely suited to supporting social enterprises' needs. These include the Public Benefit Corporation in the United States (in 32 states) and Community Interest Company in the United Kingdom. The creation of a legal structure for social enterprise in New Zealand would deliver significant benefits for the sector. This could be designed to enable enterprises to flourish, and allow them enough flexibility to each determine their own needs while still remaining accountable to the benefit they set out to deliver. Fundamentally, a new structure would increase the legitimacy of the sector and attract the benefits of a recognised identity.

Acknowledgements

The Ākina Foundation would like to acknowledge the support and feedback provided by the following parties:

- Steven Moe, Parry Field Lawyers
- Sue Barker, Charities Law
- Matt Dodd, Russell McVeagh
- Selwyn Eathorne, NZ Institute of Directors
- Dianna Suggate, Department of Internal Affairs

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Introduction

1. New Zealand's social enterprise sector is in a significant development phase, but is constrained by an ill-fitting legal framework that is not equipped to support trading and scalable businesses whose social benefit purpose is central to their existence. Various jurisdictions have established unique legal structures for social enterprises and mission-led businesses, and New Zealand is in the privileged position of learning from their experiences, good and bad. We believe it's time for a fit-for-purpose legal entity created specifically for New Zealand social enterprises, that can be a world leading example in addressing the needs of entrepreneurs, investors and ultimately, the general public.

Social Enterprise: An Overview

2. Social enterprise, sometimes branded 'profit for purpose', 'mission-led' or 'blended value' business, is generally described as a 'hybrid' activity, and it is useful to think of it as occupying the middle space on a continuum between conventional private "for profit" business and "non-profit" organisations.¹



3. The essential components of social enterprise are often considered to be:
 - the use of business models and tools;
 - to create profit;
 - in the pursuit of public or community benefit.²
4. Social enterprise provides innovative solutions to pressing social problems across a variety of sectors, particularly health, education, justice, and the environment. Accordingly, social 'missions' vary significantly.³
5. Social enterprise can:
 - drive inclusive growth and jobs, especially in the regions and deprived communities
 - foster innovation and improvement in the design, delivery and procurement of preventative and customer-focused public services
 - facilitate effective place-based solutions that harness and promote local ideas, resources, and leadership.
6. Although the social enterprise sector in New Zealand was once described as 'immature',
7. ⁴ it has rapidly grown in momentum. Across the country, considerable growth in consumer and investor demand for more socially-conscious companies and products means conditions are ripe for the creation

¹ See <https://www.charities.govt.nz/apply-for-registration/charitable-purpose/social-enterprise/>

² *Legal Structures for Social Enterprise* (Department of Internal Affairs, June 2013) at 5.

³ Di Jennings *Community Economic Development: Understanding the New Zealand Context* (New Zealand Community Economic Development Trust, New Zealand, 2014)

⁴ MJ Kaplan *Growing the Next Generation of Social Entrepreneurs and Start-ups in New Zealand* (Ian Axford (New Zealand) Fellowships in Public Policy, 2013)

of a marketplace for businesses that put people and the planet first. Start-up social enterprises are emerging and contributing to a dynamic and continually evolving ecosystem. Later this year the Social Enterprise World Forum will be hosted in Christchurch, which is evidence of, and will further contribute to, the significant growth in the profile of the sector nationally.

8. The New Zealand Government has been engaged in researching the social enterprise sector since 2012, and in November 2016 alongside other measures, the Cabinet Economic Growth and Infrastructure Committee agreed to establish a cross-agency working group consisting of Department of Internal Affairs, Ministry of Business, Innovation and Employment, Te Puni Kōkiri, and the Social Investment Unit, for coordinating initial Government action and planning a work programme.⁵

Social Enterprise and the Law

9. Social enterprise is an activity, meaning it may operate through various legal structures. Traditionally, social enterprises have had to choose between binary for-profit and non-profit structures, which has had particular implications. Non-profit structures protect social mission, and offer significant tax exemptions, but in order to finance growth they rely on philanthropy, grants, debt, and retained earnings. For-profit structures allow access to financing through investment markets, promoting financial stability and ability to scale, but open enterprises to additional stakeholders (investors) with the power to dilute the core social mission through their desire to obtain financial returns.⁶
10. Creative social entrepreneurs and their lawyers have been able to manipulate various legal structures to suit their purposes, but this is costly and inefficient. As social enterprise has grown in prevalence internationally, governments in various jurisdictions have created innovative 'purpose-built' legal structures. These specifically recognise and provide for the unique governance needs of social enterprises, and aim to overcome some of the challenges and trade-offs enterprises face when choosing between legal structures. Examples of such structures include the Public Benefit Corporation, Low-profit Limited Liability Company, and Social Purpose Corporation in the United States, and the Community Interest Company in the United Kingdom.

The New Zealand Context

11. At present, the following legal structures are available to New Zealand social enterprises:
 - Limited Liability Company
 - Limited Partnership
 - Charitable Trust Board
 - Co-operative companies
 - Incorporated Society
 - Industrial/Provident Society
 - Maori Land Trusts.
12. A survey undertaken by the Department of Internal Affairs in 2012 indicated that most social enterprises in New Zealand were operating as Charitable Trusts or Incorporated Societies.⁷ DIA considered there to be little demand for a purpose-built legal entity for social enterprise.⁸ At that time Ākina agreed that

⁵ See Cabinet Minute/Paper

⁶ D Reiser & S Dean "Creative Financing for Social Enterprise" (2014) 12 Stanford Social Innovation Review 50 at 50.

⁷ DIA, above n2, at 18.

⁸ Mapping social enterprises in New Zealand: Results of a 2012 survey (Department of Internal Affairs, January 2013)

introducing a legal structure was not a pressing need given the then-lack of understanding about where the sector would go, and other more pressing needs of the sector.

13. Ākina is in ongoing contact with social enterprises across New Zealand. We have observed a groundswell of activity taking place in the sector over the past five years, but we have also observed a number of innovative ideas being held back by the current regulatory framework. We now consider there is sufficient demand and the appropriate contextual settings to justify the introduction of a new legal form. Our position on this flows from the experiences of social enterprises, some of which will be explored in greater detail below.
14. Our vision is a thriving social enterprise sector; one that delivers social benefit to an even greater level than that delivered by more mature sectors in other countries. A purpose-built hybrid legal entity will streamline the experiences of social enterprise and other sector participants by removing road blocks to their activity, addressing their unique governance and operational needs, and increasing clarity around identity.
15. We believe providing legal recognition and legislative support for social enterprise should be a government priority, particularly given the sector's promise for New Zealand's economy and society. This is a significant leverage point for promoting the sector, and will demonstrate an openness and commitment by the New Zealand government to growth in social enterprise, as well as endorsement of the legitimacy of social enterprise activity in the New Zealand market. Additionally, it will provide a separate framework within which further interventions and incentives can be targeted.

The Problem with the Status Quo

16. While it is possible to undertake social enterprise activity using existing structures, each involves its own difficulties and restrictions on trading and fund-raising activities.
17. Charity has traditionally sought to address deep-rooted societal problems by providing goods or services free of charge to vulnerable people. In contrast, businesses have aimed to create profit through trading in goods and services. Legal structures have developed over time to meet the respective needs of these activities.
18. Social enterprise fundamentally aims to address deep-rooted social problems, through trading goods and services in sustainable and scalable businesses. Accordingly, social enterprises do not fit neatly into either the for-profit or non-profit camp, and the binary legal structures available create a 'dual-mission dilemma'.⁹

Fundamental restrictions within the existing legal frameworks

19. Social enterprises must operate within particular legal constraints, depending on the legal framework they choose to adopt. These constraints impact the type of activities the business can engage in.
20. Additionally, legal structure confers an identity at law, which can create preconceptions about what the business is or should be both for those within, and outside of, the organisation. These preconceptions can be inconsistent with the aims of the social enterprise and have the effect of undermining or slowing the progress of the business and its impact.
21. While the particular challenges faced by specific structures within each group vary slightly, many of the challenges are of a similar nature. The common challenges faced by not-for-profit and for-profit structures are discussed below. Case studies have been provided for illustrative purposes.

⁹ Dana Reiser "Blended Enterprise and the Dual Mission Dilemma" 35 Vermont Law Review 105 (2010)

Non-Profit Structures

Charitable organisations

22. Any non-profit organisation can qualify for charitable status so long as it meets the requirements set out in the Charities Act 2005, namely: that the organisation's purposes are charitable and for the public benefit, and all officers are qualified under the Act.¹⁰ The charities regulator also conducts an in depth inquiry into an organisation's activities and proposed activities in considering eligibility for charitable registration.¹¹
23. Charitable status is appealing to many social enterprises because of the trust associated with the charity 'brand', as well as the tax relief available. However, a key issue for social enterprises is the tight charities regulatory regime.
24. Despite the fact that creating public benefit is at the heart of social enterprise, many social enterprises cannot obtain charitable status because of the charities regulator's narrow legal interpretation of "charitable purpose", which is controversial, and arguably out of touch with current societal needs. For example, many of the United Nations Sustainable Development Goals would not be considered a "Charitable Purpose" as currently interpreted by the New Zealand charities regulator. Another issue in this context is the difficulty of challenging decisions of the charities regulator under the current regulatory framework, which means that, even if a decision of the charities regulator is incorrect, a charity may not be able to challenge it.¹²
25. Furthermore, the absolute restriction on the distribution of private pecuniary profit by charities creates another barrier to obtaining charitable status. This restriction is sometimes called an asset lock, and it ensures any of the charity's assets are used directly in furtherance the organisation's named charitable purpose. This makes sense for traditional charitable activity where assets are given its away, but for social enterprise the restriction on private pecuniary profits mean there can be no distribution of profits – which has implications for financing growth. Beyond this, the prohibition on creating private pecuniary profit limits activities in other ways. For example, if an organisation aimed to deliver a service to a group of people that directly improved their financial situation, this could be interpreted as creating a private pecuniary profit that will result in denial or loss of charitable status.

Case Study: Queenstown Lakes Community Housing Trust

The rising cost of housing is one of the major crises facing New Zealand, causing significant deprivation to vulnerable New Zealanders. The Queenstown Lakes Community Housing Trust is a community housing providers that was struck off the Charities register for allegedly generating private pecuniary profit. Beneficiaries of the Trust were able to purchase a portion of the house they live in or enter into a rent-to-buy scheme in order to support security of tenure.

The charities regulator's interpretation of the "private pecuniary profit" exclusion essentially limits interventions that improve a beneficiary's economic status (except in extreme circumstances). This means that in many cases, interventions that go beyond a "band-aid solution" risk an organisation losing its registered charitable status. In the case of community housing, special legislation was passed to allow community housing providers registered under the Housing Restructuring and Tenancy Matters Act 1992 to access an income tax exemption. However, despite the significant effort that was expended to give community housing entities this option, almost no housing entities have taken it up, principally because without charitable status it is often simply not possible to access funding. In other words, this expensive, reactive approach has not resolved the underlying problem.¹³

¹⁰ Charities Act 2005, section 13

¹¹ s 18(3)(a).

¹² See the discussion in Ch 10 *Regulating Charities: the Inside Story*, Myles McGregor-Lowndes and Bob Wyatt (Eds) (Routledge, 2017); and S Barker *Appealing decision of the charities regulator*, paper prepared for the Auckland District Law Society Seminar *Charity begins at... Developing perspectives on charity law*

¹³ See for example the discussion in *Fiscal consequences*, *The New Zealand Law Journal*, April 2016 at 102.

26. As a result of these restrictions, many social enterprises are prevented access to the benefits of being a charity, which include accessing the trust placed in the charity 'brand' by the public, accessing the associated grant funding, government contracting opportunities, and tax advantages, and other support.
27. If charities breach one of the restrictions, they can lose their charitable status and be subject to retrospective tax liability. They may also have to divest themselves of all their assets or pay tax on the balance.¹⁴ Consequently, social enterprises that have been able to gain charitable status become very risk-averse. The widespread uncertainty around a charity's ability to trade or the limits on this activity mean officers of the charity are likely to lean on the side of caution, which while reasonable, can be limiting for social enterprises seeking to grow their impact. Most organisations do not have the resources to investigate these difficult legal questions.

Non-Charitable Non-Profit Organisations

28. A non-profit organisation is any society, association or organisation (incorporated or not) that:¹⁵
 - does not have a purpose of making a profit for a proprietor, member or shareholder; and,
 - has a constitution that prohibits distribution of profit in any form to a member, proprietor or shareholder.
29. Not all non-profit organisations have charitable status, meaning not all are bound by a charitable purpose. However, they are limited in that they must not exist for the purpose of creating profits *for members*; this creates the common misconception that these organisations cannot make a profit at all or cannot be seen to be seeking one.
30. The structures impose duties on their organisations' officers to further the organisation's non-financial purposes for which the officers are personally liable. The risk and lack of resource in a non-charitable non-profit means that many of the concerns leading to risk-averse behaviour are equally as applicable to a non-profit organisation, even if it does not have registered charitable status.
31. In general, structures that are legally non-profit, for example incorporated societies and trusts, are inherently ill-fitted for trading activities and although they do not necessarily face all of the restrictions that face an organisation that has registered charitable status, social enterprises still veer away from them because of the difficulties of fitting into their governance requirements.
32. Challenges for both charitable and non-charitable non-profit organisations in relation to funding and financing are discussed below.

Financing for growth and innovation

33. Because of the restrictions on distribution of profit, charities and non-charitable incorporated societies are restricted in the finances they can access for growth, with financing options limited to philanthropic grants and debt.
34. Philanthropic grant funding is typically given on the basis of a project to be achieved which is aligned with the grantor's charitable purpose, for example "Feed the children of (school) for \$X". As a result, it can be very difficult to access funding to work on a sustainable business model. Similarly, government grants are typically for the delivery of a service to a government priority group. Again, this does not provide for investing in the business.
35. Furthermore, although these organisations can borrow money in the form of ordinary debt, few lenders are in the business of providing debt to social enterprises, given the unfamiliar balance sheets where profits are reinvested in pursuit of public benefit. Lenders often assume loans cannot be repaid, even though the business does have the capacity to repay.
36. Even if businesses are able to obtain a loan, it is unlikely to be used for growth in the same way patient capital can be, because the requirement of giving evidence of ability to repay at the time of taking on the loan lends this form of finance to being use for working capital or incremental growth. As a result, charities are far less suited to scaling than limited liability companies, who are able to take on long-term equity investment.

¹⁴ Sections CV 17 and HR 12 of the Income Tax Act 2007

¹⁵ See section DV 8 of the Income Tax Act 2007

Kilmarnock Enterprises is a Christchurch-based social enterprise, teaching adults with a range of abilities the skills needed to transition into open employment, through a business model which provides a variety of high quality services, including collating and packing, labelling, recycling and much more.

While Kilmarnock is well established and well respected in Christchurch, they faced difficulty in accessing a loan, because Kilmarnock's profits are reinvested into their impact, and at a glance the bank didn't see the ability to repay.

For-Profit Structures

37. The structures known as "for-profit" are so called to differentiate them from "non-profits". Though both are able to generate profits, the difference between the two is that "for-profits" are able to distribute their profits to members.
38. The Limited Liability Company structure, the most commonly used "for-profit" structure, is fundamentally built for the generation of profit for shareholders. Although the LLC form is arguably the most flexible structure, its underlying design and purpose creates a number of challenges where "profit-for-purpose" businesses adopt the form.

Traditional directors' duties and shareholders' rights aren't well suited for social enterprise

39. Internationally, directors owe fiduciary duties to the company, including the duty to act in the company's best interests. The nature of the duty and the persons to whom the duty is owed have been the subject of debate, but emphasis has traditionally been placed on maximising shareholders' financial interests, with failure to do so constituting a breach of duty. Social enterprise conflicts with this traditional focus, as directors may make business choices consistent with social mission at the expense of generating higher financial returns for shareholders.
40. New Zealand directors have a duty to act in the best interests of the company under s 131 of the Companies Act. There is considerable uncertainty surrounding whether this requires directors to maximise profits for shareholders; neither the wording of s 131, the statutory definition,¹⁶ nor the preamble to the Act identifies who constitutes the 'company' for the purposes of determining best interests, and no specific purposes are given in the Act for which directors' duties are to be exercised. Little is clarified by judicial treatment of the s 131 duty to date.
41. Whether it is legitimate for directors to consider stakeholders other than shareholders when making decisions in the interests of the company is a question closely related to corporate social responsibility discourse.¹⁷ Certain jurisdictions have included "constituency provisions" in their company statutes reflecting an expanded conception of the company's interests, however there is no provision in the New Zealand Companies Act either explicitly authorising or prohibiting taking such interests into account. Considering stakeholders is one of the New Zealand Principles of Corporate Governance,¹⁸ however the Financial Markets Authority does not clarify whether directors may do so at the expense of shareholders' financial interests.¹⁹
42. It is likely that acting in the 'best interests' of the company constitutes acting consistently with growing the long-term value of the business, in accordance with shareholder primacy. So long as a director honestly believes they are acting in the best long-term financial interests of the company, and there is no evidence of bad faith, they are likely to be able to consider non-shareholder interests without committing

¹⁶ Companies Act 1993, s 2(1).

¹⁷ William Clark, and Elizabeth Babson "How Benefit Corporations Are Redefining the Purpose of Business Corporations" (2012) 38(2) William Mitchell Law Review 817 at 830.

¹⁸ *Corporate Governance in New Zealand: Principles and Guidelines* (Financial Markets Authority, December 2014), Principle 9: "Board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose".

¹⁹ At 39.

a breach, as such considerations fall within their 'legitimate sphere of discretion' for matters of business judgment.²⁰ However, there is uncertainty regarding how courts might deal with decisions where a director prioritises stakeholder interests, knowing they are not in the long-term financial best interests of the company. Uncertainty leads to risk-averse behaviour.

43. In practice, New Zealand courts have been reluctant to review directors' decisions, assuming companies will prefer to deal with directors' actions internally.²¹ The above conversation discusses the approach a court might take – however it is unlikely that such a case will ever appear before a court. Unfortunately, this fact does not remove the risks in the minds of directors and lack of effective enforcement when it comes to social purpose may contribute to the risk of mission drift, as explained below.
44. Directors who breach their duties can be removed from office by the company's shareholders. Consequently, directors of social enterprises can become fearful of acting consistently with the decided community benefit to the exclusion of profit maximisation, because this creates the risk of liability or removal – especially when the company takes on investment.
45. Without specific legislative guidance on the meaning of 'best interests', this will remain murky territory, and directors will continue to be risk averse, erring on the side of caution (profit-maximisation).

Risk of 'Mission drift'

46. 'Mission drift' is the term given to the situation where, despite initial commitment to social mission, over time financial performance is prioritised, to the detriment of delivering social benefit – in other words the social enterprise becomes increasingly like a traditional company.
47. Most social enterprises are established by founders who aspire to create social, environmental and financial value. Accordingly, mission-drift is not a significant risk in closely held companies, as all involved are likely to value the social mission, and there is unlikely to be pressure on financial performance other than to the extent that it is important for sustainability and scaling impact.
48. Mission-drift is a particular risk when enterprises are taking on external investment. Investors may be less interested in social mission than financial opportunity, and if directors fail to maximise profit, they face the risk of liability in actions brought by profit-driven shareholders for failure to act in the company's best interests.
49. On the other hand, the risk of mission drift might sit with investors. Norms of a competitive market can seep in, thus diluting the intended purpose of the social enterprise. With no means of enforcing a social mission, investors who invest to create impact may have no protection.

Access to Grant Funding

50. Charitable philanthropic organisations and foundations may risk their own charitable status if they provide funding to social enterprises structured as ordinary for-profit companies that are not restricted in providing returns to owners, due to the private pecuniary profit restriction.
51. Typical grant funding for early stage business is generally focused on technology innovation or building export potential, and in general, social enterprise doesn't qualify for either. This constrains companies in terms of access to startup capital. Social enterprises structured as companies have very little access to capital to support business feasibility, early customer acquisition and other essential activities to get a business off the ground. This limits this activity to those that have sufficient personal wealth to dedicate time to it – rarely those that are directly affected by a problem.

Case Study: Patu Aotearoa

Patu Aotearoa is combating Māori and Pasifika obesity and social exclusion. They have received a huge amount of pressure from philanthropic organisations and government to become a charity. Both wanted to support Patu because of its impressive outcomes, but couldn't unless they fitted a specific legal mould.

²⁰NZLC above n at [286] ; Such a view was taken in *Peoples Department Stores Inc v Wise* (2004) 244 DLR (4th) 564 at [42].

²¹ Watts, above n, at 132.

Patu resisted because they hoped to scale to reach more of Māori and Pasifika around New Zealand and thought they would need investment in the future to do this. The founders had also put a lot of their own time and money into the success of Patu and believed that if it could make a profit (without compromising on outcomes), then they deserved to be compensated for the risk and effort they put in up front.

Case Study: Loomio

Key challenges: Loomio's key challenge was finding a funding mechanism aligned with both scale and social impact. Traditional venture capital was not a good fit for a company that authentically puts their social mission first. At the same time, traditional charitable funding doesn't operate at the scale or speed required for a globally scalable software company. Loomio met this challenge by designing an impact investment mechanism using redeemable preference shares, offering a fair rate of return while protecting the company's social mission. The design and implementation of this instrument required considerable resource in the form of both pro-bono and paid services.

Existing Solutions

'Creative Lawyering'

Company Constitutions

52. Companies have the flexibility to set their own purpose and create suitable governance structures through their constitution. It is possible for a social enterprise structured as a company to include mission in its founding document and create accountability mechanisms, such as altered director duties. Such clarification can provide directors with the assurance they need to legitimately act in accordance with a prioritised social mission, and can create a barrier against mission drift. However, this is an example of 'creative lawyering' that requires significant resource, and is not accessible to all businesses. Furthermore, innovative use of legal structures can often act as a deterrent to investors and philanthropists, who may be fearful of the implications for their own liability.

Multiple structures

53. Companies have the most flexible legal structure, which is why many social enterprises use it as the base for a more creative arrangement. Some social enterprises are able to create their own unique legal identity by using multiple structures, for example by trading through a company, which is wholly or majority owned by a charity. This means purpose is protected, but the business has the ability to take on investment and growth capital. The company acts in the best interest of its parent, and the direction of the company is ultimately controlled by a charity that is beholden to its own public benefit.

Why existing solutions aren't adequate

Lack of recognition, legitimacy and deprivation of identity

54. The social enterprises operating in existing markets in New Zealand currently suffer from a lack of brand-recognition. Legal structure is necessarily intertwined with identity, perception and organisational culture.
55. We consider this to be the most compelling argument for the creation of a new legal structure. Social enterprises have a fundamentally different identity to companies, or charities, or non-profits, and they are currently deprived an identity and legitimacy at law and, consequently, in society. Trying to make them fit within the existing legal structures and associated market norms is inefficient and will ultimately deter entrepreneurs from trying.

56. Social enterprise is an unfamiliar concept to many New Zealanders, which makes it risky in the eyes of funders and investors. This increases due diligence costs for investors, increases the cost of capital for social enterprises and creates an additional barrier to finding the right kind of financial or professional support. It also means other essential sector players won't engage outside the binary charity/company model, as they are suspicious of the motives of social enterprises, and simply believe they are doing it "wrong". Alternatively, the funder's own legal framework means they are prohibited from engaging with social enterprises. This all acts as a barrier to realising the potential benefits that social enterprise can deliver.

Case Study: Kilmarnock Enterprises

Kilmarnock has identified that following key challenge: "A lack of understanding of social enterprise can cause confusion: businesses view Kilmarnock as a charity, and charities view it as a business."

Beyond this, unless Government takes the initiative to define its expectations of the sector, the social enterprise 'brand' is in danger of being abused. The business opportunity for "conscious businesses" is increasing, and the term social enterprise is completely unregulated and vulnerable to being used for "green washing" or "social washing". This could seriously undermine the sector; instead of being seen as a case of deceptive behaviour, even just one event of this nature could cast public suspicion over the sector as a whole.

'Creative Lawyering' downsides

57. Adapting available legal forms to suit unique and often entirely novel needs requires considerable creativity within and around existing legal frameworks. It works to align all stakeholders and remove some risks, but it is expensive and inefficient.
58. Such 'creative lawyering' simply isn't accessible to many social enterprises, due to its cost in both time and money. Furthermore, this is likely to be uncharted territory for many lawyers, who may prefer to stick to what they know, thereby "hammering a square peg into a round hole".
59. Altering a constitution is a possibility, but is likely to require significant explanation to anyone becoming involved with the company, and it lacks the brand recognition and legitimacy that a legal structure would create.

Appropriate Financing

60. As identified above, amending constitutions doesn't solve other issues, such as the difficulties involved for charitable foundations wanting to make grants to non-charitable companies. Additionally, anything that is unknown or complicated increases risk and therefore deters investors.

Little room for adding incentives in future without complex reform

61. At present it would be impossible to attach any benefits (tax or otherwise) to social enterprise as a sector (as has been done with the charitable sector) because social enterprises are difficult to identify and are not registered in one place.
62. The provision of certain benefits has been incredibly powerful in the pioneering stages of social enterprise in other jurisdictions. Social enterprises have to operate in existing markets, essentially having to compete with purely commercial companies in a system that is built for the latter. A new, purpose-built structure would allow barriers to social enterprise to be resolved, independently of and without having to wait for reform of issues relating to charity regulation in New Zealand.

The Objective of this Project

63. In the Ākina briefing for Ministers we identified "confusion around charities legislation, inefficient legal structures, and real and perceived regulatory barriers that constrain investment in the sector" as one of seven key barriers to productivity in New Zealand.

64. The objective of this project is to equip social enterprises with a structure that creates efficiency rather than constraints them, that attracts the benefits of a recognised identity, and is flexible enough that each social enterprise can determine its own needs, while still remaining accountable to deliver the benefit it sets out to achieve. In order to do this it is essential to convince those with the power to legislate of the necessity of a new structure.

65. In Cabinet's meeting on social enterprise last year it identified,

"Investment in establishing and administering a social enterprise register is not a priority. The concept has not been discussed by the wider social enterprise sector and likely uptake is unclear... In any case, work on defining social enterprise, which is yet to be scoped by Statistics NZ, would be a necessary precursor. "

Work to scope the sector is now underway by Statistics NZ, and we consider we have a window of opportunity in which to demonstrate to Government the importance of a new legal structure for the sector. To do this, we need to have a comprehensive understanding of the problem, and a strong proposal for a legal structure supported by the confidence of the wider social enterprise sector.

66. The following sections explore some case studies of legal structures and legal statuses that have been implemented overseas. The final section will set out the characteristics of a new legal structure in New Zealand that would remedy the issues set out in this paper above.

A New Legal Structure: The Social Purpose Company

A new legal structure would be the simplest and most effective means of creating an enabling legal framework for social enterprises. A new structure creates a completely separate identity. As well as overcoming the actual or perceived legal barriers, an identity supports the sector by giving it a higher profile and greater cohesiveness with the growing network and voice of these bodies.

The proposed characteristics of a new legal structure, including legal safeguards and transparency requirements would provide reassurance to stakeholders engaging with social enterprise. It would also provide protections to the sector, but placing these requirements on any organisations that seek to label themselves a social enterprise.

A fit for purpose legal structure is quick and easy to set up, without the hassle of choosing between equally ill-fitting structures and then crafting them to fit the organisations need. This removes a major capacity and cost barrier for social enterprises.

Form

We suggest that a new social enterprise legal structure bases itself on the existing companies structure. This structure was is flexible and designed to support trade and growth, which is important for social enterprises that seek sustainability and scale.

Under the Companies Act, an organisation can begin with the statutory legal framework which is permissive of a very broad range of activity, and tailor it over time to fit its specific governance needs if they arise. The companies structure is broad enough to encompass co-operative activities, providing benefit to the wider community or to a single shareholder organisation providing a socially beneficial service.

The company form is a familiar structure that is well understood with the business community in which a social enterprise has to operate.

Asset Lock

We suggest that there is no formal asset lock in the new legal structure in the sense that a certain amount of profits must be reinvested. This kind of asset lock means that the organisation's assets are used directly in activities that further the mission of the organization. It is increasingly recognized that the benefit of being able to raise investment to scale operations, while indirect, can be an incredibly powerful tool for impact and sometimes requires the distribution of assets.

Instead of having a hard line restriction on the distribution of assets, we think it is preferable to regulate the distribution of assets. For example, just as a director must consider and certify matters with respect to issuing shares in a company, the officers of a social enterprise should:

- Consider the trade off between reinvesting designated profits and the benefit that accrues from any arrangement in which the right to participate in profits is given;
- Determine which path is likely to be more beneficial in terms of furthering the social enterprise's stated purpose; and
- If the directors chose to give rights to participate in profits, certify that, in their reasonable opinion, it was justifiable in the circumstances in terms of furthering the social enterprise's stated purpose.

Circumstances in which profit distribution might be justifiable include:

- Incentivising employee's performance by aligning them with the success of the social enterprise;
- Using profit participation as a means of repaying growth or other investment capital;

- Distributing profits to a community or stakeholder segment (eg. A vulnerable population) where such distribution would further the purposes of the social enterprise.

The requirements for directors to resolve that any distribution of assets is intended to further the social enterprise's social purpose and to certify that, in their reasonable opinion, it is intended to further the social enterprise's social purpose should be compulsory statutory requirements.

Mission Lock

Just as a charity must set out its charitable purposes in its governing documents, a new social enterprise legal structure should set out the social purpose for which the organisation exists.

Embedding the organisations purpose in its governing documents provides the following benefits:

- Continuity of purpose
- Clear signal to stakeholders
- Provides context for director's duties

These benefits allow more efficient interactions with stakeholders because everyone (officer's, shareholders, employees, investors, customers) is aligned on the organisation's purpose and knows where they stand.

With the organisation's social purpose embedded in its governing documents it is clarified that profit maximization is not the aim of its activities. This means that director's duties, such as the duty to act in the best interests of the company, are interpreted in the context of why the organization was created.

The requirement to embed social mission in the social enterprise's governing documents should be a compulsory statutory requirement.

Officer's duties

Most officer's duties in a company structure will be suitable for a social enterprise. The main source of controversy under the exiting company structure is the meaning of acting in the best interests of the company and the nature of the director's fiduciary duty. A new structure should instead place a duty on the officers of a social enterprise to act in furtherance of its social or environmental purpose, as set out in the purpose statement. In doing this officers may take into account:

- The interests of various stakeholders;
- The financial sustainability of the social enterprise;
- The benefits of scaling the operations of the social enterprise to scale impact.

This redefinition or clarification of the director's duty to act in the best interests of the social enterprise should be explicitly set out in statute to avoid the confusion and resulting inefficiencies that exist when working in the current framework.

Transparency and Reporting Requirements

The above requirements set out duties and elements of a legal framework. These are important safeguards, but even more important in terms of achieving impact is how social enterprises will be held accountable for its social impact performance and for operating inside these frameworks. In order to ensure that social enterprises are working towards their stated purpose, they should be

required to report on their performance. This could be as simple as submitting a high level strategy or theory of change and reporting annually on key success indicators. It will not be necessary for social enterprises to meet certain performance standards, but they will be required to be accountable for their performance.

A social enterprise should report annually for public scrutiny on the following activities:

- The social enterprise's activities and impact on their chosen community or problem
- The remuneration paid to its directors
- The assets transferred other than for full consideration
- Dividends paid and an explanation of how this furthered the its social purpose
- Steps taken to evaluate impact, including consulting stakeholders, and the outcomes of the evaluation.

These reporting requirements should be compulsory statutory provisions.

Enforcement

The officers' duties above are included to protect the mission of the social enterprise. They would of course involve a level of discretion as to how to meet the duties. For the most part, it would be up to the social enterprise itself (the board of directors and shareholders) to ensure that individual directors and the board were acting in accordance with their duties and other statutory provisions. Shareholders and employees will have the right to challenge directors on decisions that they believe are not in furtherance of the social enterprise's mission.

Where there is a gross breach of duty to act in furtherance of the social enterprises stated mission, directors would be personally liable to a fine in accordance with the Companies Act.

Governing Body

In the first instance the Registrar for Companies could govern social enterprise. This seems like the best fit based on the close relationship between the ordinary company and the social purpose company. In the longer term, as the numbers of social enterprise sector grow, a stand-alone regulatory body could be established to provide greater scrutiny and guidance in the sector.

Transitional provisions

There are currently a substantial number of social enterprises operating under existing legal frameworks that would benefit from transitioning to a new structure. Any law reform should include provisions for transferring to the new legal structure to remove any legal barriers.

Additional Policies

This paper does not seek to set out all the policies that are needed to support social enterprise, however, there are issues and barriers set out in this paper that would not be addressed by a legal structure with characteristics set out above. These include:

- Access to early stage funding for innovation, research and development. This requires policy or legal change to make funds accessible through government grants or allowing charitable foundations to make grants to mission locked (but not asset locked) organisations.
- Incentives for investors to engage with something unknown and therefore perceived to be riskier, especially where expected return is below market rate. Other jurisdictions have

implemented tax advantages for investors (e.g. Social Investment Tax Relief in the UK), which is similar to the benefits afforded to donors to organisations that have done status. This provides a financial incentive and for investments that project lower than market rate returns, it allows them to compete in traditional commercial investment markets.

Appendix: Overseas Context

Overseas jurisdictions have addressed the needs of social enterprises through various legal structures and statuses. The majority of examples are found in the United States and Europe. Below we set out a cross section of general-purpose structures and statuses. For efficiency, we have not included every overseas example in this section, but have selected examples that represent the spectrum of approaches used.

Each of the examples involves either:

- amendments to an existing legal form (in the case of structures), or
- additional rules that are applied to any existing legal structure (in the case of statuses).

Certain legal elements recur across the various structures and statuses. This paper examines the following 4 key elements:

- Asset lock
- Mission lock
- Transparency and reporting requirements
- Enforcement provisions

Definitions:

Asset Lock

This is a general term used to cover all the legal provisions that restrict the distribution of company assets (including any profit generated). Together these provisions ensure all assets are devoted to the community the company was established to benefit.

The asset-lock stems from the principle that the core purpose of a social enterprise is to deliver public benefit rather than create private profit. The provisions are designed to ensure the primary social purpose is clear to directors and shareholders alike, by considerably restricting the distribution of private profit. The asset lock is a permanent step that cannot be reversed, intended to prevent mission-drift in perpetuity.

Generally an asset lock comprises the one or both of following:

Restricted Distribution of Assets

- o Assets cannot be transferred other than for full consideration (market-value), unless the transfer falls within a narrow range of permitted transfers, such as to another asset-locked body or for the benefit of the community.
- o Assets cannot be returned to members of the organisation unless they are asset-locked bodies themselves. Limited exceptions to this rule do exist, including capped payments of dividends (explained below) and the return of paid up capital on liquidation.
- o Payment of directors and staff is permitted, but they may not be paid more than market value

Dividend Cap

- o A maximum cap on the distribution of profit (variable) ensures a certain percentage of profits are reinvested into the enterprise or used for the community the company intends to benefit.
- o Proponents of the CIC consider this restriction “strikes a balance between encouraging investment in CICs and the principle that profits should be devoted to community benefit.”

Mission Lock

Mission lock is the term given to the provisions that together embed the consideration of social mission (and sometimes stakeholders’ interests) into the obligations of directors, confirming acting according to these interests is in the best interests of the company. This releases directors from the risk of liability for failing to maximise financial returns

Embedded Social Purpose

- Enterprises specify a public benefit purpose within their articles of association and shareholder certificates

- A specified threshold of shareholders voting is required to change this purpose. This elevates the company's intended public benefit to the status of law.

Expanded Directors' Duties

- Directors are bound by all traditional directors' duties, but these are redefined and expanded as a result of the entrenched social purpose and accountability provisions included in the legislation.

Transparency and Reporting Requirements

These statutory provisions require companies to disclose certain information about their business practices for public scrutiny. Sometimes a third-party reporting standard is required, and sometimes the reports are accessible on a central register (like the New Zealand Charities Register). Activities that might need to be reported include:

- Assessment of impact or public benefit
- Details of officer's remuneration
- Use of assets
- Distributions

Enforcement provisions

Some structures or statuses give rights to certain parties to take action to enforce social purpose provisions and duties in addition to existing enforcement proceedings.

Structure/Status		Community Interest Company (CIC) – Status UK
Asset Lock	General	Required to include statutory asset lock in articles of association, set out in prescribed format.
	Restrictions on Distributions	CICs may only declare a dividend by resolution of its members.
	Dividend Cap	May pay dividends to shareholders who are not asset-locked bodies, so long as these do not exceed the prescribed maximum aggregate dividend cap 35%.
Mission Lock	Embedded Social Purpose	CICs must have a purpose for benefit of community and pass “ community interest test ”, meaning it must be able to satisfy the regulator that it would be regarded by a reasonable person as being in the community or wider public interest. Can be changed in accordance with the terms of the CICs memorandum and articles, but must also be approved by the CIC Regulator.
	Director’s Duties and Protections	Directors owe the same obligations as those set out in the UK Companies Act.
Transparency and Reporting Requirements		Required to report regularly to CIC regulator on how it has carried out its purpose, consulted with stakeholders, and delivered benefits to the community. It must also report on remuneration paid to directors, assets transferred and dividends paid. This report is placed on a public record for public scrutiny.
Enforcement		If the asset lock is breached remedies rely on existence of government regulator of CICs. Primarily, each company is to ensure the asset-lock is complied with, but in the event of a breach, the regulator has a broad range of enforcement powers, including the power to appoint and remove directors, appoint managers, or intervene to protect company property.
Other Features		Most investments into a CIC will be eligible for social investment tax relief (SITR), which incentivises investors to invest in CICs by providing a higher effective rate of return.

Structure/Status		Public Benefit Corporation – Structure USA (B Labs Model)
Asset Lock	General	N/A
	Restrictions on Distributions	
	Dividend Cap	
Mission Lock	Embedded Social Purpose	<p>Must include a ‘general’ public benefit, and may include a ‘particular’ public benefit in articles of association.</p> <p>A ‘minimum-status vote’ of two-thirds shareholders is required in order to change the purpose, which is intended to provide ‘mission security’ for the company.</p>
	Director’s Duties and Protections	<p>In discharging their duties and considering the best interests of the company, the board of directors, and individual directors are obliged to consider the effects of any decision on a broad range of stakeholders, including shareholders, employees, customers, beneficiaries of the stated public benefit, the community as a whole, the local and global environment, the short and long-term interests of the company, and the ability of the corporation to continue to deliver its stated public benefit.</p> <p>Directors still have discretion, and need not give priority to a particular interest over any other interest, unless the corporation has included its intention to prioritise certain interests in its articles</p>
Transparency and Reporting Requirements		<p>Annual Benefit Report published on the Benefit Corporation’s website. This report must include:</p> <ul style="list-style-type: none"> • Narrative on progress towards impact including activities, progress and challenges • An assessment of overall social and environmental performance against a third party standard (including reasons for deviating from the standard if applicable) • Details of directors, including remuneration, and significant shareholders.
Enforcement		<p>Legislation creates “Benefit Enforcement Proceeding”, enabling company, or certain parties derivatively, to ensure directors remain accountable to the mission. BEP is “any action for failure to pursue or create the public benefit purpose set forth in its articles; or violation of any obligation, duty, or standard of conduct under the benefit corporation legislation”. The company, and its directors are relieved from financial liability in the case of a BEP.</p> <p>When a director has otherwise satisfied traditional duties, any action for failure to pursue or achieve public benefit, or violation of the standard of conduct required by the benefit corporation statute, is confined to a BEP.</p> <p>NB: Directors do not owe any enforceable duty to stakeholders, their expanded fiduciary duties are owed solely to the company. BEPs may therefore be pursued either directly by the corporation, or derivatively by shareholders holding a minimum stock, directors, or third parties as specified in the articles. The proceeding has not yet been tested in court.</p>
Other Features		PBCs may choose to give third parties right to enforce purpose (voluntary)

Structure/Status		Social Purpose Corporation - Structure California, USA
Asset Lock	General	N/A
	Restrictions on Distributions	
	Dividend Cap	
Mission Lock	Embedded Social Purpose	<p>A SPC may include a dedication in its articles to one or more of the following “special purposes:”</p> <ol style="list-style-type: none"> 1. One or more charitable or public purpose activities that could be carried out by a California non-profit public benefit corporation; or 2. The purpose of promoting positive effects of or minimizing adverse effects of the social purpose corporation’s activities upon any of the following, provided that the corporation consider the purpose in addition to or together with the financial interests of the shareholders and compliance with legal obligations, and take action consistent with that purpose: The SPC’s employees, suppliers, customers and creditors, the community and society or the environment. <p>The special purpose(s) in the Articles of Incorporation may be eliminated or amended by a two-thirds majority of voting shares or such higher amount as set out in its articles.</p>
	Director’s Duties and Protections	In addition to the existing right of a corporation’s directors and officers to exercise their business judgment as provided under California law, SPC directors and officers also have the ability to make decisions that specifically offset maximization of profit with the special purpose(s) set forth in the corporation’s Articles of Incorporation when, in their business judgment, such a decision is necessary and appropriate.
Transparency and Reporting Requirements		Additional reporting requirements include a discussion and analysis of efforts to measure the impact of the SPC’s activities relating to its special purpose or purposes.
Enforcement		Standard enforcement rights may be applied, including the removal of directors and bringing a claim for breach of fiduciary duty.

Structure/Status		Enterprise Solidaire d'Utilité Sociale (ESUS) – Status France
Asset Lock	General	This social purpose must have a significant impact on the business as measured by: <ul style="list-style-type: none"> - over the last three fiscal years at least 66% of the operating expenses must have been spent on activities related to the social purpose; or ESUS must adhere to dividend restrictions (see next column).
	Restrictions on Distributions	<ul style="list-style-type: none"> - The average amount (salary and bonuses included) paid to the five highest paid employees or executives cannot exceed seven times the legal minimum wage AND the highest paid employee or executive cannot exceed 10 times the legal minimum wage.
	Dividend Cap	<ul style="list-style-type: none"> - The ratio between the cost of dividends and financial products over equity and financial products is less than the average rate of yield of bonds in private companies + 5%. - Shares cannot be traded on a regulated market (ie the company must not become public).
Mission Lock	Embedded Social Purpose	The primary aim of the organisation must be a social purpose (d'utilité social), and this must be set out in the organisations articles of association. The definition of "d'utilité sociale" is focused primarily on providing assistance to vulnerable persons or activities that remedy discrimination or inequalities within society. (NB this is narrower than the European definition of "social benefit")
	Director's Duties and Protections	N/A
Transparency and Reporting Requirements		Must publish its environmental and social impact in its management report.
Enforcement		As for underlying structure.

Structure/Status		Social Purpose Company - Structure Belgium
Asset Lock	General	The governing documents must state that "the members are only seeking a limited profit or no profit", that they "do not seek as the main aim of the company to procure members any indirect profit" (where the company provides members with a direct limited profit, it may not exceed a rate of return currently set at 6 percent) The constitution must also set out "a policy for distribution of profits appropriate to the internal and external purposes of the company". In case of liquidation, "after all the liabilities have been met and the members have been repaid their capital, any surplus should be allocated to purposes as close as possible to the social purpose of the company".
	Restrictions on Distributions	
	Dividend Cap	N/A
Mission Lock	Embedded Social Purpose	Must have an altruistic purpose, being a social objective that the shareholders wish to realise and that is the decisive motive for the incorporation of the SPC rather than the enrichment of its members. Details of the social purpose must be set out in the SPC's bylaws.
	Director's Duties and Protections	N/A
Transparency and Reporting Requirements		As for underlying structure.
Enforcement		As for underlying structure.
Other Features		The SFS also introduces a certain degree of democracy into the enterprise: the constitution must set out "practical procedures whereby each member of staff may acquire membership status, one year after joining the company at the latest". They also state that "no-one taking part in a vote at the general assembly may exercise a number of votes exceeding one tenth of the votes deriving from the shares represented; this percentage is one twentieth where one or more members are staff members engaged by the company"

Structure/Status		Benefit Corporation (Proposed) – Structure Australia (B Labs Model)
Asset Lock	Generally	N/A
	Restrictions on Distributions	
	Dividend Cap	
Mission Lock	Embedded Social Purpose	<p>A benefit company must have a purpose of creating general public benefit in its constitution and may have a purpose of creating one or more specific public benefits in its constitution.</p> <p>75% of voting shares required to approve an amendment to the purpose statement.</p>
	Director's Duties and Protections	<p>Expanded directors' duties to require directors to consider the mission, and the interests of non- financial stakeholders in addition to the financial interests of shareholders.</p> <p>But need not give priority to a particular matter over any other matter, unless the benefit company has stated in its constitution that the directors must give priority to certain matters related to the accomplishment of its general public benefit purpose or any specific public benefit purpose in its constitution.</p>
Transparency and Reporting Requirements		<p>Annual Benefit Report published on the Benefit Corporation's website. This report must include:</p> <ul style="list-style-type: none"> • Narrative on progress towards impact including activities, progress and challenges • An assessment of overall social and environmental performance against a third party standard (including reasons for deviating from the standard if applicable) <p>Details of directors, including remuneration, and significant shareholders.</p>
Enforcement		Benefit enforcement proceedings can be brought against a benefit company on two grounds, being a failure of the benefit company to pursue or create general public benefit or a specific public benefit purpose in its constitution, or a failure to comply with the reporting obligations

Conclusion

This paper has outlined the current structure options available for social enterprises and the inadequacies of those structures. The time is right for the introduction of a new legal structure which addresses the unique needs of social enterprises. Such a new legal structure in the form of a Social Purpose Company would both raise the profile of the social enterprise sector as well as provide a tailored legal framework that is ready for the next generation of social entrepreneurs to use.