



Social enterprises and legal structure options in NZ

01 September 2017 - By Steven Moe

LAWTALK 910 (/SEARCH/_NOCACHE?
META_C_AND=910)

Alice: Would you tell me, please, which way I ought to go from here?

The Cheshire Cat: That depends a good deal on where you want to get to.

Alice: I don't much care where.

The Cheshire Cat: Then it doesn't much matter which way you go.

- Lewis Carroll in *Alice in Wonderland*

nonth we looked at what social enterprises are (<https://www.lawsociety.org.nz/practice-resources/practice-areas/not-for-profit/what-is-a-social-enterprise>) (*LawTalk* 909, pages 34-35). While the definition is still not set, essentially these are entities that combine both the desire to act 'for purpose' with the desire to be 'for profit'. The next generation of entrepreneurs is increasingly focused on more than just profit and whether they know it or not, they will probably fit in the definition of 'social enterprises'. This article looks at how that social enterprise concept fits within the existing legal framework in New Zealand and also examines what options some are proposing for change to help the growth of this sector.



On 9 December 2016 Cabinet released a paper, "Social Enterprise and Social Finance: A Path to Growth". It did not have concrete reform plans for the social enterprise sector, but instead it emphasised a cross-agency working group, the collection of statistics for further analysis and studying ways to encourage investment. That is important and there is a lot of time and energy currently being spent on ways to create a better ecosystem for social enterprises. However, some are arguing that more fundamental change might be needed if there is to be a growth in social enterprises.

The United Kingdom, Canada and United States have all developed new types of social enterprise entities in the last decade. The key paper starting the UK process was issued in 2002, 16 years ago, so this is not a new concept. However, in New Zealand it seems that we may let the 'number 8 wire' approach take over and simply make do and work within the existing frameworks. What can we learn from those overseas experiences and what alternatives might they suggest for New Zealand?

Current options for social enterprises

A common structure for social enterprises is to set up a charitable trust which (eventually) incorporates a limited liability company as a subsidiary to run its profit making trading arm. There is limited research on this, but a Department of Internal Affairs 2012 paper on this topic pointed to 421 respondents which it had surveyed. Of those 52% were set up as charitable trusts. Incorporated societies made up 37% while limited liability companies made up only 7%.

The three most common 'vehicles' used for setting up a social enterprise are:

- **Incorporated charitable trust:** A charitable trust needs to have a charitable purpose at its core and profit is not distributed to private individuals. It can register with Charities Services and apply for donee status so that donations are not taxed. This approach can limit the scope of what such an entity does since it is constrained by staying within those purposes.
- **Incorporated societies:** The Incorporated Societies Act 1908 provides that members can form a society, with a minimum of 15 members. The constitution or rules must set out its objectives. This option is sometimes chosen by social enterprises.
- **Limited liability companies:** In a company profit is typically distributed to shareholders but it is possible to 'write in' (by restrictions on activities) some social enterprise purposes in the constitution of a company. Companies (with charitable purposes) can also register as a charity.

Other structures which may be used are co-operative companies, Māori land trusts, limited partnerships and industrial and provident societies but these are more rarely seen.

Difficulties with available structures

One of the main issues for any new business is access to capital. Adoption of a charitable trust structure lends itself to approaching individuals and groups for philanthropic grants or donations (particularly if it has tax exempt status). However, it is more difficult to attract private investors who share the risk since these entities do not return profits to shareholders and remain 'charitable' under the Charities Act 2005. On the flip side of this dilemma, a limited liability company may struggle with attracting such private funding since there is an assumption that it is 'for profit' because of the form of entity which is being used – whereas in fact it may have other objectives beyond returning a profit. Building charitable purposes into the constitution will still need explanation and the default assumptions of investors will need to be clarified.

What other options are there?

There is value in social enterprises because they do not rely on government funding or donations and instead operate as a business which employs people. However, their goals are not traditionally profit driven and instead may work to advance cultural, environmental, educational, social or other goals. They may also employ marginalised people and build locally based businesses, which can contribute to particular geographic areas more than mass market or franchise models.

There are many barriers for social enterprises to overcome before they can flourish. It is easy to become distracted by all of those important issues (lack of specialised incubation, mentoring, funding options, financial and business experience, and immature support networks). The list is a long one although it is getting better. One could well argue that those issues need to be addressed prior to focusing on any development of a new legal structure. However, some are suggesting that changes made now might mean that social enterprises do not need to twist themselves around in order to fit within current legal structures.

So, what are some of the options being discussed?

Option A: Do nothing?

One option is to do nothing and continue to allow new social enterprises to pull out the number 8 wire and make do with existing structures available to them. That might be where things end up, but instead of making do with what we have, some are saying that a bold and innovative new approach is required (see options B and C below). This would place the debate about social enterprise and what it is at the top of the list on the table for discussion. It would raise awareness and ensure this was also front of mind for those who are creating such businesses. This would also ensure that the broader community and traditional 'for profit' businesses could be challenged in their thinking and assumptions about their own business as well, such as where they source their suppliers

Option B: New legal structure?

Other countries have adopted legal structures specifically with social enterprises in mind. In the United Kingdom these are 'community interest companies', in the United States there are 'benefit corporations' and in Canada there are 'community contribution companies'.

The fact that there is not a greater call for a change may be a symptom of people facing other more pressing day-to-day challenges and not knowing that there might even be another option. Proponents of a new legal structure argue that if new structures were available that might also be a way to address those pressing concerns of sourcing investors and funding, explaining the vision of a social enterprise and raising awareness of this sector. To be specific, a new form of legal entity introduced could have the following key elements:

- **Clear name:** A name for the new form of entity which makes it clear it is not a traditional limited liability company but also not a trust or incorporated society. This would assist to alert investors and others as to what type of entity it is.
- **Purposes:** Requirement for clear articulation of the purposes (eg, social, environmental, cultural) which show how they align with the social good while wrestling with the tension of also being a business.
- **Capped dividends:** Restrictions in place on returning profits to investors to ensure that profit making is not the 'primary' objective.
- **Tax exemptions:** Make the structure flexible enough so that for those who wanted to do so, and meet criteria, could still apply for tax exempt status, at least for the non-profit portion of their income.
- **Reinvestment:** Profit/surplus to be reinvested into the purpose. Consider if there is a guideline or percentage fixed of what must be reinvested or it is left as a dynamic tension.
- **Reporting:** Include a requirement for reporting not just on profit making goals but also on other social benefit goals.
- **Director duties:** Reform of the duties so directors consider new objectives beyond profitability.

Many of these concepts are foreign to traditional 'for profit' business models and would take time to be discussed and understood. That there could be something more than maximising financial returns will take time to penetrate into the consciousness of society. The publicity around the new form of legal entity might raise awareness of social enterprises in New Zealand. As a result, they would gain a new level of legitimacy. In addition, investment would be encouraged so they can grow because investors would understand this option.

Option C: A new legal status?

If a new legal structure is going too far, another option is a new legal status. This status could be granted by the Government to those entities which satisfy certain criteria along the lines of those set out in Option B in terms of reinvestment, entrenched social purposes and reporting. Some would argue that this is the appropriate first step rather than trying to reform the entire sector by introducing a new legal structure.

A new legal status might be akin to a 'B Corporation' which was discussed in the article last month – it would give a level of credibility to those social enterprises which satisfied the criteria. But then again, why reinvent the wheel; maybe there should be no change and those who want to can just go through the B Corp assessment instead.

Conclusion

Where are we, and where do we want to be? This article has outlined the current legal structures in New Zealand used by social enterprises and has looked at a few of the options that could be considered to introduce reform. A 2002 report on charities in the UK which still seems to resonate here said:

“Much of the legal context for charity and voluntary action is now outdated ... law and regulation have not kept pace with developments ... There is also insufficient recognition in the legal system of the particular needs of social enterprises, a rapidly growing group of businesses carrying out a wide range of activities for the benefit of society rather than the individual. This report sets out a package of measures which will modernise the law ...”

The result in the UK was the introduction of a new form of legal entity more than a decade ago. Is now the right time for social enterprises to be given a new framework in which to operate here? Not unlike Alice in the quote at the start, we first probably need to work out where we want to go. How we get there will be complicated as there are many competing interests and points of view. Further discussion and engagement on this issue is important. With the social enterprise world forum being hosted in Christchurch in September, now might be the right time to consider this issue more.

*Steven Moe stevenmoe@parryfield.com (<mailto:stevenmoe@parryfield.com>) is a senior associate at Parry Field Lawyers in Christchurch. He recently wrote a book, *Social Enterprises in New Zealand: A Legal Handbook*, which is available as an eBook to those who send him an email.*

Last updated on the 1st September 2017