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RECOMMENDATION AREA FOUR:
BUILDING THE CAPABILITY OF ENTERPRISES

Providing Guidance on Company Structures

Recommendation 4.2

PREPARED BY THE ĀKINA FOUNDATION
as part of The Impact Initiative

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Background

The Government plays a vital role in supporting the development of New Zealand businesses. However, there's work to be done to support more businesses and enterprises to develop the capability to generate wellbeing outcomes.

The impact that social enterprises create makes them the best of business but their uniqueness means that they face unique barriers to accessing existing business support. Targeted changes are required in order to create the conditions that will enable more impact-led businesses, including community, Māori and Pacific enterprises, to start and to thrive.

This can be done by expanding existing business capability development services to include tools and resources that focus on impact, combined with enabling intermediaries that understand the unique value of social enterprises to provide on the ground support. Guidance around ways to use business structures to enable impact will help clarify the best ways for enterprises to protect and manage their impact. Together, these recommendations will help develop the pipeline and scale of impact-led businesses to move on to procurement and investment opportunities.

About The Impact Initiative

This paper was produced for the Social Enterprise Sector Development Programme, publicly known as The Impact Initiative.

The Impact Initiative is a partnership between the Department of Internal Affairs on behalf of the New Zealand Government and the Ākina Foundation, supported by the Community Enterprise Network Trust (CENT).

To find out more about the programme visit The Impact Initiative website:

www.theimpactinitiative.org.nz

Te Tari Taiwhenua Internal Affairs ākina CENT

Recommendation 4.2

Provide guidance to impact-led businesses and their advisors to enable impact to be protected and managed within a Limited Liability Company.

Extensive programme research by industry professionals has identified that social enterprises face unique challenges due to the perceptions held around legal structures in Aotearoa New Zealand. Simply put, there are entrenched views about the purpose of a business and the purpose of a charity. Such perceptions result in social enterprises facing a higher level of scrutiny than other businesses and the actions they take in response to this often limits their ability to innovate and grow.

The perceptions that create these challenges, however, are not reflected in legislation and can be overcome by educating businesses and their advisors on how to protect and manage their impact within a Limited Liability Company. When this is effectively done, impact-led businesses more broadly will be better placed to innovate and grow within existing legal structures.

KEY TERMS

- **Impact** refers to the broader social, environmental, cultural or economic change (as determined by the people experiencing the change) that occurs as a result of the business or activity
- **Impact-led businesses** are businesses that are led by a social or environmental purpose. This group includes businesses that identify as **social enterprises** as well as other businesses and organisations (like Māori and Pacifica businesses) that may not identify with this term, but are committed to and led by their impact
- **Impact protection** refers to how impact is protected through legal mechanisms within a company's governing documents that ensure the impact cannot easily be changed over time
- **Managing impact** refers to actively considering, measuring, reporting and improving impact over time

What are the current challenges?

Social enterprises have often claimed that existing legal structures in Aotearoa New Zealand are not fit for purpose, because they do not reflect both the profit and purpose goals of the business. To better understand exactly how social enterprises are affected by the available legal structures in Aotearoa New Zealand, the programme conducted in depth research in partnership with legal and research professionals. The findings were published in a 2019 report titled '*Structuring for Impact*.'[1]

Almost all social enterprises interviewed for *Structuring for Impact* felt disadvantaged by their legal structure. That disadvantage was caused by perceptions in the market around how a business should operate, (particularly if that business is focused on impact), rather than by

[1] https://www.theimpactinitiative.org.nz/publications/structuring-for-impact

legislative requirements. In Aotearoa New Zealand there is a commonly held perception that profit is delivered by business and broader social and environmental impact is delivered by charity.[2] As a result, entities that explicitly aim to deliver both profit and impact are often met with a variety of challenges including questions around the integrity and suitability of pursuing impact and profit at the same time.

As a result of these challenges, impact-led businesses seek additional ways to demonstrate and protect their impact, often through legal mechanisms such as charitable status or other more complex structures. 'Protecting impact' is also encouraged when bringing on investment. New investment will often bring in new business owners and sometimes new and divergent interests in the business. By protecting the business's impact, business owners entrench it into the business and prevent any new owners and/or interests from changing or diluting that impact over time. While charitable status or complex structures do help to protect impact they also disadvantage the business because they add compliance burdens, and can confuse investors and lenders and there are simpler ways of achieving the needed protection.

Crucially, the programme research highlighted multiple instances where an impact-led business was not able to access capital to grow their business because of this confusion. The reasons for this differed and include:

1. Investors deeming the structure, created to protect the impact, as too complex to understand
2. Charitable status preventing businesses releasing equity
3. Banking advisors were confused by the charitable aspects of a business and the challenges of lending against this, and
4. Grant funding was not available because the business did not have charitable status, meaning it was possible to raise investment funding however it could not receive grant funding.

In limiting businesses access to capital, their longer term innovation, growth and viability is also limited.

The most common legal structure for social enterprises is a Limited Liability Company (LLC). While the legislation that regulates LLCs[3] does not explicitly contemplate impact protection mechanisms, it does not exclude it either. Instead, the LLC is a flexible entity that enables company Directors or Shareholders to add a variety of impact protection mechanisms as required. This could be as simple as:

- Adding a clause in a company's constitution which states the intended impact of the company
- Specifying how it must be considered in certain decisions of company directors, and
- Preventing that clause from being changed by requiring higher portions of shareholders to approve doing so.

These approaches are simple solutions that will be less confusing to investors, while not creating unnecessary compliance burdens for the business and increasing their access to capital in the process. It is also important to note that, as more and more businesses are driven by a social or environmental purpose, despite maybe not considering themselves a social enterprise, these approaches to protecting and

[2] See section 1.2.2 of [Structuring for Impact]

[3] Companies Act 1993

managing impact are also relevant. Businesses are increasingly considering their broader purpose beyond solely financial profit and embedding this within their legal structure is the next step, hence this has the potential to apply to a large portion of the private sector.

The knowledge amongst both business owners and professional service providers of the above solutions within the LLC structure is unfortunately relatively low as is deeper knowledge around other ways to protect and manage impact for businesses.

It is also noted that this flexibility makes the LLC a suitable structure to incorporate other values into the legal entity, such as values from Te Ao Māori, and in doing so to enable the structure to more deeply demonstrate and protect the intention and values of a business.

What would overcome these challenges?

To support more impact-led businesses to access and raise capital, there needs to be increased awareness by all stakeholders in the business ecosystem of the simple and effective ways to protect and manage impact within a Company. This can be achieved by creating and distributing education for business owners, investors, and professional service providers around how to protect and manage impact. This could include example clauses to add to a constitution to demonstrate and protect impact. Additional steps may be considered, such as how to manage impact when raising capital. As part of the programme, we have created some example guides on these areas and work is now required to help businesses owners access this information.

Alongside how to protect their impact, businesses should also be supported to measure and report their impact. Doing so not only demonstrates to the market the impact they are having, but also enables investors, procurers and consumers to easily see this information and incorporate it into their decision-making. More information on how this could be done is provided in the ‘What could be done next’ section below.

Solving this problem should avoid the complexities which are developing within social enterprise legal structures. In doing so, it will reduce the compliance burden for these businesses, while increasing their capacity to innovate, access capital, raise investment and grow all aspects of their business and impact.

What work has been done already?

The primary activity of the programme in understanding this challenge and identifying possible solutions was preparing the *Structuring for Impact* report. Following this report we have had several meetings with the Commerce, Consumers and Communications branch of MBIE to discuss the report findings and next steps, as well as business.govt and Companies Office teams. Through this we have prepared some indicative resources and a work plan that sets out how government can help educate business owners on protecting and managing their impact.

What could be done next?

To overcome this challenge, there are three key areas to focus on:

1. Education on how to protect and manage impact

2. Develop methods to monitor impact led enterprises

3. Support broader reporting to demonstrate impact

1. Education on how to protect and manage impact

Ākina and MBIE can collaborate to create resources that demonstrate best practice methods of protecting and managing impact within companies to ensure that it has strong integrity without becoming a barrier to investment (see Recommendation 2.1 for more information on what we mean by 'managing impact').[4] Such resources should be developed specifically for the various stakeholders involved in the business ecosystem, including business owners, professional advisors, and investors, so all can better understand how to manage impact within existing legal structures. These resources could then be distributed via relevant business departments such as business.govt, New Zealand Trade & Enterprise and the Companies Office.

2. Develop methods to monitor impact focused businesses

The intention of such education and guidance is to enable impact-led businesses to better access capital and innovate and grow through that. Another important step that will better enable others to transact with and invest in impact focused businesses by making it possible for impact focused businesses to identify as such on the New Zealand Business Number (NZBN) register, enabling a range of data to be captured to better identify other ways to support these businesses in the future.

An amendment to Schedule 4 of the New Zealand Business Number Act 2016 would enable businesses to indicate within their NZBN that their 'business is led by a social or environmental purpose' for example. This is already an option for Māori businesses, and doing so for impact businesses would deliver similar value, enabling government to better understand the number of these businesses and their growth over time, as well as enabling businesses and investors to identify and transact with such businesses, and in doing so grow the impact they deliver.

3. Support broader reporting to demonstrate impact

An important part of demonstrating the impact of a business is reporting that impact to stakeholders. Doing so enables investors, consumers, employees and procurers to easily see the impact a business is contributing to, while also enabling government to understand the contribution of that business to our wellbeing. In Recommendation 2.1 we provide more detail on how government could build its capability to measure impact, a precondition to reporting impact. Enabling businesses to also report their impact is an important next step. Doing so would further enable these businesses to demonstrate the impact they're delivering and reduce any confusion that they may otherwise cause. We suggest that the Government works alongside appropriate stakeholders to develop a voluntary annual social and environmental impact reporting framework that enables this.

A draft work plan which sets out how these steps can be actioned and the stakeholders who would be involved has also been prepared. Please contact Ākina for more information on this.

[4] Recommendation 2.1 is detailed alongside the other recommendation white papers at https://www.theimpactinitiative.org.nz/publications/white-papers

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The Impact Initiative (The Social Enterprise Sector Development Programme) was allocated $5.5m in government funding over three years. It is delivered by Ākina in partnership with the Department of Internal Affairs and with support from the Community Enterprise Network Trust (CENT).

The programme concludes in March 2021 with the delivery targeted recommendations outlining the next steps for the Government to support the ongoing development of social enterprises, as well as opportunities for the Government to tap into the impact social enterprises create. The recommendations have been developed with government agencies and with consultation from sector representatives.

PROGRAMME PRIORITIES

- Understanding and supporting the conditions for a thriving social enterprise sector in Aotearoa New Zealand
- Making it clear how social enterprise is contributing to government's economic, social and environmental goals
- Working with the Government to articulate what it needs to do to support social enterprises, after the programme.

PROGRAMME PARTNERS

Te Tari Taiwhenua Internal Affairs
ākina
CENT

Programme activity highlights

- Uncovering the ways in which social enterprises deliver against the Government's priority areas
- Developing cross agency and public-private working and advisory groups to collaborate on social enterprise
- Uncovering legal barriers for social enterprise and exploring ways to address these
- Testing ways to support and grow social enterprises through place based networks
- Engaging strategically with government to support the development of broader outcomes through social procurement
- Developing and growing Aotearoa New Zealand's first social procurement marketplace (Fwd) and enabling access for government buyers
- Supporting social enterprises to access capital and get ready for impact investment
- Creating and testing business development tools and resources for social enterprises.