RISK ISSUES AND SOCIAL ENTERPRISE IN CANADA[1]

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Foreword

SiG@MaRS, the Social Innovation Generation program at the MaRS Discovery District in Toronto, provides services to social entrepreneurs who come to MaRS to get help with their social enterprise or social purpose business. Regardless of the stage of development, the issue of incorporation comes up: "Should I incorporate as for-profit, not-for-profit, or a charity?" Or my favourite question: "Is there something in between all those options that is for organizations that want to make money and make a difference?"

In the spring of 2011, I read an article by Jim Fruchterman, a seasoned social entrepreneur in the US, who wrote an article in the Standford Social Innovation Review entitled For Love or Lucre (Fruchterman, 2011). The article provides a guide to those who are thinking through the thorny question of whether to create a nonprofit, a for-profit, or something in between.

The article was great but was written from Jim's experience in the US, so when I ran into to Jim at the Skoll World Forum in March, I asked him if we could "Canadianize" his article. He agreed, and we contracted with Susan Manwaring to write a paper for our audience. Susan is a Partner at Miller Thomson, a law firm with whom we have a relationship. Susan with her associate Andrew Valentine developed the resulting paper: Social Enterprise in Canada: Structural Options (http://www.marsdd.com/socialentrerprise) and this article is a summary of that work.

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Introduction

The past decade has seen an explosion of interest in the subject of social enterprise[2] – in Canada and elsewhere – as well as dramatic growth in the number of entities and ventures that fall within this broad category.[3] Social enterprise offers a range of possibilities for combining for-profit and nonprofit goals, as well as the possibility of pursuing philanthropic ends without relying on the traditional means of financing charitable ventures: government grants and private donations. While social enterprise is still in its relative infancy, great promise has been seen by many seeking to pursue socially beneficial goals outside the traditional nonprofit model (the limits of which are becoming increasingly apparent).[4] However, as is true of anything with great promise, these initiatives also raise risks that must be considered before concluding that social enterprise is the solution to the problems faced by sector organizations.

The concept of "social enterprise" is itself subject to a wide range of interpretations.[5] Some have defined it as simply the incorporation of greater fiscal discipline into the operation of charities and nonprofits. More commonly, however, the term refers to the use of revenue-generating business-like activities to accomplish, at least in part, a socially beneficial end.[6] This definition is itself very broad, and it is clear that there are many different structures that fit within this basic concept – from business corporations designating a portion of their profits for charitable or social ends, to charities and nonprofits establishing subordinate for-profit entities or operations to finance their nonprofit purposes, to charities and nonprofits conducting for-profit operations that directly advance their community or philanthropic purpose.

This article is an excerpt from an article that considers the various structural options for social enterprise from the perspective of a social entrepreneur contemplating a new social venture. The excerpts used highlight the issues that have to be considered from a risk perspective. A very relevant question for any entity embarking on a social enterprise, whether it be a registered charity, a nonprofit, or a for-profit, is what risks are inherent in the venture and how will such risks be mitigated and addressed.

It is said that of every ten for-profit start-up businesses, only two will succeed. This is a critical reality that should not be forgotten by social sector organizations turning to the "social enterprise" model as a way to address funding deficiencies and the rising need for services. This is not to suggest that organizations should not consider revenue-generating activities, but, rather, it is to highlight the importance of doing so only after completion of a proper business plan and consideration of the risks of embarking on the initiative. The discussion below focuses on the issues that should be considered before proceeding with the proposed social enterprise.

Preliminary considerations

Fruchterman (2011) lists four basic issues that prospective social entrepreneurs must address before deciding on an appropriate structure. Some of these issues relate to the basic goals and the vision underlying the proposed enterprise, while others relate more to the practical requirements – financial and otherwise – of the activities to be carried on. Falling into the first category are the issues of *motivation* and *control*. The second category considers the issues of the *market* in which the enterprise will operate and the *capital* requirements of the operation.

(a) Motivation

This issue addresses the question of what the venture in question is fundamentally intended to accomplish. Is the primary goal of the venture to generate private profit or to further a social mission, and how central is the social mission to the organization? While these goals are not mutually exclusive, their relative importance will influence the optimal structure as they will often come into conflict during the life of the enterprise.

Like start-up businesses, many new social ventures will ultimately fail to achieve sustainability (Seedco Policy Centre, 2007). If the venture struggles to generate revenue, this will lead inevitably to questions about the extent to which the operations of the venture can be changed or new revenue opportunities pursued to improve the financial sustainability of the enterprise. These options may conflict with the social purpose of the venture or may threaten to shift the focus of the organization away from its social mission. Given this potential tension, it is vital to have a clear guiding vision of the factors that will determine the extent to which the operations of the venture can be changed to accommodate new sources of revenue. This factor is also important when deciding whether or how long a venture should continue to operate at a loss.

Thus, prospective social entrepreneurs need to ask themselves how they will define success. Will it be personal wealth or making a positive difference in the community? Consider also how outside pressures will influence the definition of success. If outside investors will be involved, there may be pressure to define success in terms of the returns delivered to investors. How important is the social mission to the investors? If the principal operator or investor in the enterprise is a charity, then the social mission must be paramount.

Related to the question of the venture's fundamental purpose is the question of the personal (or institutional) motivation of the social entrepreneur(s) and investor(s) who will drive and finance the venture. As with any business venture, the start-up of the business will likely entail sunk costs that cannot be recouped if the business fails and which may never be recouped even if the venture achieves sustainability. Investors in the enterprise must decide whether this is acceptable. They must also decide, again, on whether success will be defined primarily in terms of financial or social returns. If financial return is the primary goal of the venture – either as a source of personal profit or as a method of funding a related charity – then the optimal structure may be one that affords greater flexibility to adapt to changing financial conditions and to pursue economic opportunities. If the social goal is paramount, investors may wish to choose a structure that ensures that the social purpose remains the dominant factor in operational decision-making. Social entrepreneurs are generally striving to achieve both social impact and financial return, but for the purpose of determining the appropriate corporate structure, it is recommended that one motivation be identified as primary, even if only slightly so.

(b) Control/Governance

The question of how and by whom control over the venture will be held is central to the structural decision. Whereas there is considerable flexibility in how a for-profit organization may be controlled – particularly one that is not publicly traded – entities that benefit from favourable tax treatment are generally subject to greater limitations on the extent to which a single person or related group may control them as well as the factors that must be considered when making operational decisions.

Prospective social entrepreneurs will therefore need to consider the extent to which they can operate and fund the venture themselves, and the extent to which it may be necessary to share control with outside investors or others. The greatest flexibility comes when a social entrepreneur or founding organization can retain complete control over the operational decisions. As soon as control is split, different interests and priorities may come into competition. Prospective entrepreneurs should consider the potential for damage to existing relationships when such differences arise.

Legally, a for-profit corporation is controlled by its shareholders, who are responsible for the election of the board of directors and whose economic rights in the entity are protected by statute. A nonprofit corporation is similarly controlled by its members in that the members are responsible for the election of the board of directors. However, the members do not have an economic interest in the entity and thus the character of the control is somewhat different.

If investors become shareholders or members of the corporation, consider how this will affect the operation of the venture. If they are able to elect members of the board sympathetic to their position – which may not align with those of the founder – or if they join the board themselves, they may be in a position to influence the corporation. It is important to consider at the outset how much formal control the founder is willing to share.

Likewise, it is also important to consider that, depending on the structure of the venture, control may be shared not only with other investors or stakeholders but also with the public interest. Charities and nonprofit organizations are subject to strict limits on the purposes for which their funds may be spent, and the public interest is required to be foremost in the decision-making of the organization. This can entail additional regulatory supervision over the operations of the organization.[7] It is important to select partners who understand this requirement and who are committed to the furtherance of the organization's social purpose.

The issue of transparency is also a factor to be considered. The level of public disclosure of the organization's finances and operations, as well as information about the directors and officers, varies depending on the structure and tax status of the organization. A registered charity, for example, must make annual filings containing detailed information concerning its activities and finances.[8] It must also disclose the salary ranges of all its most highly-paid employees and the names of its directors. This information is publicly available. Accordingly, social entrepreneurs must consider the extent of disclosure with which they are comfortable.

(c) Market

It is important that prospective entrepreneurs consider and understand their market. This requires consideration of the customers, the value proposition, and the competition. As with any business, the success of the venture will depend on understanding and thinking through these issues.

Understanding the customer is perhaps the most important consideration. What need is the venture intended to fill? What community will be served? What expertise will be needed regarding the needs of the customers, and how will this expertise be accessed? Are the customers who will *use* the product or service provided by the venture the same people that will *pay* for them? If those funding the venture will be different from the end-users, how will these funders be attracted to the venture?

Related to this, it is important to consider the size of the market and the potential for profit. The scale of the operations, as well as the relative ease with which the venture is anticipated to be profitable, will influence whether to structure the venture as a for-profit or nonprofit. Generally speaking, the larger and more readily profitable the proposed venture, the more a for-profit structure may make sense. If, by contrast, it is expected that the venture will be difficult to make sustainable in absence of support through donations and grants, then a nonprofit structure may be more appropriate.

It is also important to understand the competition that the venture will face. Even if there are no other providers of the goods or services that the venture intends to provide or sell, other players in a market may compete for the dollars that might otherwise be spent on the venture's products, and the nature of this competition may influence the selection of an appropriate structure. For example, if a for-profit business is seen as exploiting a community, there may be space for a nonprofit to enter the market. By contrast, if a nonprofit organization is seen as insufficiently responsive to the needs of the community, this may present the opportunity to enter the market using a business approach that places a business-like emphasis on customer service.

Finally, the value proposition of the venture must be addressed. How will the product or service to be provided be differentiated from those already available in the market? This question is important when determining the structure of the venture. If the venture intends to sell goods or services that are already available in the marketplace, then this will create an additional challenge in having the venture registered as a charity or maintaining status as a nonprofit organization. Charities and nonprofits are subject to restrictions on the types of business activities that they may carry out, and one of the factors which may be relevant to the Canada Revenue Agency (CRA) when evaluating whether a revenue generating activity of a charity or nonprofit is acceptable is whether it competes with products and services provided by for-profit organizations.

(d) Capital

One of the fundamental determinants of whether a venture will be structured as a for-profit or nonprofit are the capital requirements of the enterprise. Will the venture be funded by investors who expect to be repaid or receive a return on investment? If so, it will be necessary to determine the likelihood of generating sufficient returns to pay such investors. If they are unlikely to be repaid, then it will be necessary to determine whether the venture can be funded entirely out of the funds of the founder or whether traditional sources of nonprofit funding – grants and donations – will need to be factored into the business model.

Prospective social entrepreneurs need to consider their capital needs both at start-up and on a going forward basis. The funds needed at start-up may influence the structure of the venture. If the venture can be initiated with relatively low costs, then there will be greater flexibility in terms of structure that can be employed. If, however, the venture will require significant start-up costs, it may be necessary to prioritize flexible financing when determining the structure of the enterprise. Likewise, it is necessary to consider the need to access outside capital to grow the business. Even if the business becomes profitable or sustainable, it may not generate sufficient revenue to finance the desired growth or expansion of the operations. If this is so, then the ability to access outside capital will again be relevant. Generally speaking, greater needs for capital and financing flexibility – and in particular the need to be able to issue share capital – will suggest a for-profit structure.

When considering the capital requirements for the venture, it is particularly important to determine the likely ability of the venture to obtain loans. Nonprofit organizations and charities cannot generally access share capital and so must rely on debt financing (in addition to grants and donations) as a means of attracting capital. Thus, if a social entrepreneur is leaning toward structuring a venture as a nonprofit, it will be important to consider whether the venture will hold assets that can be borrowed against, making it a better candidate for commercial loans.[9] To the extent that a charity or nonprofit organization may wish to make loans to other nonprofits – either as a way of raising funds or to further a social purpose – the organization will need to be aware that any such loans must comply with strict requirements if made at below-market rates of return.[10]

Prospective entrepreneurs should also consider the significance of an exemption from income and property tax in their proposed venture. Charities and nonprofit organizations benefit from a general exemption from income tax (see subsections 149(1)(f) and 149(1)(l) of the *Income Tax Act*). Some also may qualify for exemptions from taxes on real property. These exemptions are attractive to the extent that an organization will generate a significant surplus from operations or will hold significant amounts of property that would otherwise be subject to tax. However, if no such profit is expected and the organization does not anticipate holding significant amounts of real property, then the tax exemption granted to nonprofits under the *Income Tax Act* or property tax legislation is of less importance. While such tax exemptions are not the only factor making status as a charity or nonprofit organization attractive – the ability to present the organization as a nonprofit or charity and potentially to issue tax receipts for donations is also significant – the absence of profit and property will diminish the importance of maintaining tax-exempt status.

Conclusion

To summarize, there are a number of critical issues that must be considered by organizations before they embark on a social venture. These issues require a good analysis of the potential for success along with a good analysis of the risk inherent in embarking on the enterprise. Recognizing and then managing these risks will help to achieve a successful enterprise rather than one that fails, and worse yet, causes damage to the organization(s) that promoted it. With proper advice and sound planning, social enterprise will be a vital component of the voluntary sector in Canada.

Notes

1. This article is adapted from an article drafted by the same authors entitled Social Enterprise In Canada: Structural Options, found at (http://www.marsdd.com/social enterprise). The original article was adapted for Canadian readers from the work of Jim Fruchterman, who discussed structural options for social enterprise from this perspective in the US context (Fruchterman, 2011). The focus of this article is on the preliminary considerations that Fruchterman emphasized as crucial before making decisions on how to proceed with a social enterprise.

2. The terminology in this area is not entirely settled, and the terms "social enterprise," "social purpose business," and "social venture" are sometimes used as distinct concepts and sometimes interchangeably. The emerging terminology favours using "social enterprise" when charities and nonprofit organizations earn income through business-like activities to accomplish a social mission, "social purpose business" to refer to for-profits with a social mission, and "social venture" as an umbrella term encompassing both of these concepts. In this article, while we have tried to use this terminology where possible, we have not strictly maintained this nomenclature. Given that "social enterprise" is still frequently used as an umbrella term, we have used it in this fashion in this article.

3. See the *Social Enterprise Census 2010: A Summary of Results from the Social Finance Census of Nonprofits and Social Purpose Businesses* (Malhotra, Laird, & Spence, 2010). The Census notes that 50% of all social enterprises operating in Ontario were established in the last five years.

4. See, for example, Mulholland, Mendelsohn, and Shamshiri, 2011.

5. For a summary of the various meanings attached to the concept of "social enterprise," see Mair, Robinson, and Hockerts, 2006, pp. 4-6.

6. This is essentially the definition used by the Canadian Task Force on Social Finance: "Social enterprise is generally understood to mean any organization or activity that uses the market-oriented production and sale of goods and/or services to pursue a public benefit mission" (Canadian Task Force on Social Finance, 2010, p. 32).

7. The public interest in charities is regulated by the Attorney General of the relevant province. In some instances, the Attorney General's authority to regulate charities is delegated to the Public Guardian and Trustee (PGT). Ontario is a notable jurisdiction in which the use of charitable property is regulated by the PGT.

8. Charities are required to file form T3010 each year, which contains detailed disclosures regarding the operations and finances of the charity. A copy of this form is available at http://www.cra-arc.gc.ca/E/pbg/tf/t3010-1/README.html .

9. Some organizations are also experimenting with other forms of debt financing. The Centre for Social Innovation in Toronto, for example, has developed a form of Community Bond to finance certain projects. These are RRSP-eligible investments allowing

individuals and organizations to invest in CSI, earning 4% rates of return over a five-year term. See http://socialinnovation.ca/communitybonds .

10. Such investments by charities are subject to rules under both the *Income Tax Act* and under provincial trust law. CRA sets out its policies regarding Program Related Investments in "RC4143 Registered Charities: Community Economic Development Programs" (December 23, 1999): http://www.cra-arc.gc.ca/E/pub/tg/rc4143/rc4143-e.html. Essentially, CRA takes the position that investments in non-qualified donees must be made at market rates of return. Charities must also always consider the investment standards prescribed for trustees of charitable property – they must "exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments" (for example, see section 27 of the *Trustee Act*). Failure to meet these standards can result in sanctions from the Public Guardian and Trustee.

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