Case 7.3 – NewCo Model Rules

Available from: **www.newco.org.uk**

Background

NewCo emerged out of collaboration between Bill Barker and Dave Thornett at the Sheffield Community Economic Development Unit (SCEDU) and Morgan Killick [1], the founder of ESP Projects Ltd. In the mid-1990s, Morgan was completing an MA in Political Economy while running a web-design business. His desire to combine social responsibility and entrepreneurial agency coincided with SCEDU's suggestion that he incorporate his business as a social enterprise. He accepted the offer and company rules were commissioned by SCEDU to his requirements, and these were then revised extensively in collaboration with Bill Barker.

Historical Development

The rules owe an intellectual debt to Polanyi's *The Great Transformation* and other texts that Morgan encountered during his MA in Political Economy. These conceptualised economic transactions in their wider social and cultural context, and rejected the naked 'self-interest' that modern day economists and business people claim underlies the economy. He saw that employees and the wider community stood to gain as much by enterprise as the entrepreneur so it was only right that they should be joint owners and backers of the business.

After a period of study, Morgan was left asking the question "*was there a structure available that could re-entrench these other interests within a business model?*" He found that there was not, so he set about creating a corporate form that issued ordinary shares to three classes of shareholder: entrepreneurs and investors; employees (through an Employee Benefit Trust) and social economy customers. He felt strongly that these specific three 'voices' were needed in the governance of the organisation, so model Articles of Association were drafted accordingly. Where the costs of establishing an employee trust are prohibitive, shares can be offered directly to staff. The structure is designed to prevent deadlock by allowing employees to become members and have a decisive vote where entrepreneurial and social economy interests diverge. In early 2004, the model included three categories of ordinary shareholder:

Class A shares are offered to social entrepreneurs and private investors founding the enterprise
Class B shares are offered to social economy organisations (who may be customers)
Class C shares are offered to employees

In late 2004, the concept of *social equity* was introduced. The idea was to provide a mechanism for investors of patient capital. The rational for introducing a new class of share was to help overcome situations where ordinary shares have been issued, and existing shareholders are not willing to dilute their shareholding. *Social equity* was believed to provide a useful option to raise capital without offering full voting rights.

At present, pre-emption rights exist (allowing existing class B shareholders to decide which organisations they will recognise). This means that they can decide how new shares offered by the company should be allocated between existing and new shareholders (in their own category only). This can act to limit the development of the investment and customer communities. A new iteration of the model rules is planned to clarify (and perhaps limit) pre-emption rights, and also to review the definition of a social economy organisation for the purposes of membership. It is only recently that the EU (and some member states) started to define this in accounting practice and laws clarifying the nature of a social economy organisation. As a result of this, new iterations of the rules can provide the clarification needed to expand Class B membership.

Key Features (what is unique about them?)

The central feature of a NewCo is a tripartite power structure based on three classes of ordinary shareholder, supplemented by social equity shares to raise patient capital. Classes A, B, and C are treated equally (as a single group) for the purpose of paying dividends and disposing of assets, but – by default - have different powers in enterprise governance. Typically, Class A and B shareholders have more power to elect and remove directors, chair meetings, and must be present to achieve a quorum and transact business. Class C shareholders hold the balance of power rather than participating as an equal partner in decision-making, with the intention that their voice and vote is decisive when there is a conflict of interest between Class A and B members.

Each *social equity share*, by default, is sold for £2,500, and is redeemable after 99 years. Unlike ordinary shares, it does not rise or fall in value and takes the form of a fixed-dividend preference share. In one implementation, a fixed dividend of £125 per share (5%) is paid to social equity shareholders before dividends are paid out to ordinary shareholders.

A key benefit of the corporate structure is its attractiveness to potential social economy customers who immediately take a greater interest than may be the case with a traditional private sector supplier. Trust is established through the offering of shares, and there is recognition that the founders seek to share trading benefits to foster productive collaboration. Another benefit is the scope for entrepreneurial agency. By default, the quorum requirements are modest (for a General Meeting it is three people, of which one must be a Class A shareholder; for a Board Meeting one Class A director and Class B direct must be present). Day to day decision-making is relatively free of bureaucracy, and does not suffer unduly from the need to coordinate meetings with large numbers of stakeholders.

Limitations

After the start up period, it has proved easier to engage Class C, rather than Class B shareholders in governance. This is interesting in light of experiences in the Mondragon Cooperatives (see Case 2.1), where secondary cooperatives have revised their governing institutions to accommodate similar issues. Class C shareholders have a direct interest in most activities through their employment rights and obligations, while Class B shareholders are interested to the extent that dividends strengthen their own social economy enterprise.

As profitability increases, Class B shareholder interest increases, but a tension also grows between Class B and C shareholders. As Class B shareholders have more power to appoint directors, and can receive dividends without contributing labour effort, some resentment from Class C shareholders can develop. Discussions are underway to consider how this might be resolved in future iterations of the model rules, and how pre-emption rights might be amended to enable increases in the shareholdings of Class C shareholders after profitable years of trading.

In practice, social equity shares have proved less attractive than anticipated due to the length of the period of redemption. Few investors are willing to tie up capital for so long – so a review of the interest rate and its link to the bank of England base rate (perhaps with annual opportunities to redeem) may prove more popular with various funders. The presence of 'private' shareholders also means that NewCo companies sometimes fail to meet investment criteria for social enterprise funding because of variations in the way funders understand and recognise social enterprise.

[1] Morgan Killick was awarded Social Entrepreneur of the Year in 2008 at the Yorkshire and Humber Social Enterprise Awards.

Sources: Based on interviews with Bill Barker, 2003 and Morgan Killick 2010. Additional information retrieved from ESP Projects Ltd incorporation documents, Memorandum and Articles of Association 1999, 2004 and 2008.