Case 7.4 – Surplus Sharing Model Rules

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Background

Surplus sharing model rules for social enterprise have been created by Dr Rory Ridley-Duff at Sheffield Business School. They evolved initially as a result of debates at Computercraft Ltd (a London-based worker cooperative) after it was unable to secure loan or equity finance for the redevelopment of its primary software product. The rules made it possible to retain cooperative management while making the company more attractive for member investment and external funders. Over the last 10 years, new iterations of the model rules have evolved to reflect further research findings and practical experience of corporate governance and organisation development.

Historical Development

The rules are rooted in the work of Gavin Boby and Guy Major. In the mid-1990s, Guy Major published papers in cooperative journals on the need for *voting shares* (which determine who controls the enterprise) separate from *value-added shares* (used to determine the distribution of financial surpluses). Guy Major teamed up with Gavin Boby (a barrister from Bath) to form a company called Democratic Business Ltd. Their model rules created a structure that operated on the basis of one-person one vote for decision-making, but distributed surpluses according to percentages agreed during incorporation (normally 50% each to workers and investors).

Their contribution was part of a debate in the cooperative sector on differentiating voting and investment rights (leading also to the Blue 3 rules introduced by ICOM in 1997). The directors of Democratic Business Ltd argued that withholding profits from shareholders (by allocating them directly to reserves) was a subversion of the cooperative principle that capital should be democratically controlled by members. They preferred to follow more closely the practice at Mondragon (in Spain) by which profits are distributed to both individually and collectively owned investment accounts. This way, a board of directors would not be able to ignore company members: they would have persuade members (on an annual basis) to reinvest capital in the business. The company's capital belongs to members in a practical rather than theoretical sense.

A precursor of the publicly available model rules was developed by First Contact Software Ltd in 2000 with the help of Sheffield Cooperative Development Group and Democratic Business Ltd. These acted as a springboard for discussion with School Trends Ltd, one of the companies featured on the website of the Employee Ownership Association (EOA, 2007, 2009). Two features influenced School Trends conversion to employee-ownership: the first is legal membership for all permanent staff. Each member acquires one vote after a year's service. Staff members elect a Governing Council empowered to appoint the Managing Director. The second feature is the allocation of individually and collectively owned shares ('free shares') in proportion to the profitability of the company each year. A minority of shares are individually owned, while others are collectively owned (and allocated to an employee account in an Employee Benefit Trust).

The first public domain version of the rules followed a period of advice to a company established by Dr Poonam Thapa. She wanted to establish a fair trade company with cooperative management and a secure way of preventing "mission drift". To accommodate this, Founders shares were introduced that allow those founding the social enterprise to convert an ordinary resolution (requiring a simple majority of votes) into a 'special resolution' that requires majority support from founders, workers and investors separately. Founders, therefore, can prevent proposals created by the workforce, or by investors, from subverting the social objectives of the organisation. These model rules were published by the Common Cause Foundation under a Creative Commons Licence in 2007.

Key Features

The rules provide for three classes of share: **Founder**, **Labour** and **Investor Shares**. *Founder Shares* are self-explanatory. *Labour Shares* are issued to represent the labour investment of workforce members, and can be issued to contractors and suppliers as well as employees who provide *continuous* labour contributions for more than a year. *Investor Shares* are issued to represent the financial contribution of the workforce, customers, and others acknowledged as partners in the enterprise. *Investor Shares* can also be used to support social investment by issuing them to an employee or charitable trust, or other social economy organisation.

Investor Shares are similar to ordinary shares: they are tradable and can rise and fall in value reflecting the asset strength and future prospects of the company. An important provision is a mechanism to distribute an agreed proportion of profits to the workforce in the form of new shares, so that all members of the workforce gradually increase their shareholding as a reward for good financial performance. Similar mechanisms have been used in other social enterprises (e.g. Sunderland Care Home Associates) to help the workforce acquire ownership over time from another organisation, creating a stable and gradual way to effect a succession plan.

There are some key similarities to Geof Cox's *Stakeholder Model Ltd* (see Case 7.1).

- Founders Shares are similar to Stewardship Shares.
- Labour Shares are similar to Partnership Shares.
- Investor Shares are similar to Investment Shares.

What makes the arrangements different, however, is that all shareholders have one vote in General Meeting. This makes the running of General Meetings easier, and provides all stakeholders with an opportunity to make proposals, speak and use their vote, irrespective of the nature or size of their shareholding. Only if two or more members want a 'poll', or a class of shareholders converts an 'ordinary resolution' to a 'special resolution', are more complicated voting procedures invoked. A poll for an ordinary resolution still limits the influence of Labour and Investor Shareholders (normally they are each allocated 50% of the voting rights). This means that controversial proposals must be supported by members of both groups to secure a majority. Secondly, if one group of shareholders converts a proposal to a 'special resolution' then all groups must vote in favour separately, and 75% of all shareholders must vote in favour.

Limitations

These rules are not appropriate if the goal is to secure grants and donations from charitable sources. Some difficulties were also experienced explaining them to Business Angels (who disliked the one-person, one vote provisions). As a result, they are suitable mainly for employee and community ownership through direct share allocations, and are likely to attract support only from specialist social enterprise and employee-ownership investors willing to purchase equity (such as the Key Fund, Baxi Investment Trust or Triodos Bank). Charitable and philanthropic investors typically insist on a more conventional 'asset lock' arrangement through a CLG or CIC because they believe sharing surpluses with the workforce through dividend payments is tantamount to supporting private enterprise. As investor shares are tradable and dividends are uncapped, this business form may be attractive to *equity* investors interested in supporting social entrepreneurship.

Lastly, as the rules have been in the public domain under a Creative Commons Licence – rather than from a specialist provider - it is not known how widely they are used.

Sources:Academic articles by Guy Major and Gavin Body; Model Rules of Democratic Business Ltd; Articles of Association retrieved from Companies House: First Contact Software Ltd, Social Exchange Ltd, New Horizons Music Ltd; Documentation online at http://www.scribd.com/doc/14113137/