Sean Campbell – Bertram Scholarship Essay

February 21, 2022

Social purpose organizations (inclusive of charities, not-for-profits, co-operatives, and for-profit social enterprises) have begun to use direct public offerings (DPOs) of debt instruments and (for social purpose organizations with share capital) shares to raise funds from both accredited and non-accredited investors to: (1) advance their social or environmental mission, (2) refinance more expensive debt, and/or (3) acquire equipment or property. DPOs are a new and evolving area of practice for social purpose organizations and pose unique governance challenges. For example, the social purpose must be weighed against the economic necessity to provide a sufficient return to attract investors, the organizations are exposed to new risks (e.g., default on issued debt, rising interest rate environment), new staff and board competencies are required (e.g., compliance, finance), and the organizations must conform to new regulations (e.g., securities regimes, Income Tax Act, charity regulations).

New and evolving areas of practice do not operate in a vacuum. Institutional isomorphism—a branch of institutional theory developed by DiMaggio & Powell (1983)—seeks to understand the coercive (e.g., laws and regulations), mimetic (e.g., efficiency through imitation), and normative (e.g., need for legitimacy) pressures that shape an organization. These isomorphic pressures limit innovation and the possible governance frameworks that can be adopted by a social purpose organization that engages in DPOs.

Thanks to the generous support of the Canadian Foundation for Governance Research's 2021 Bertram Scholarship, I have had the opportunity to analyze the offering documents of social purpose organizations that have conducted DPOs, interview social purpose organization leaders and experts, and undertake an action research project to develop the governance and finance structure for an emerging social purpose organization DPO. Action research is an important, although undervalued, form of inquiry in the social sciences that inserts the researcher into an organization (as opposed to the traditional observer role) to solve a real problem.

My action research focuses on Union Co-operative, a new organization that I co-founded with the goal of raising investment capital through DPOs to acquire properties for "permanent rental affordability through community ownership." The model is informed by the traditions of affordable housing organizations (e.g., non-profit and co-operative housing, community land trusts) and community finance (e.g., renewable energy co-operatives, non-profit community bonds).

The following are examples of governance tensions faced by Union Co-operative, the institutional pressures that constrained and directed governance innovation, and the strategies developed through this action research process to overcome the governance tensions.

Member Decisions vs. Speed and Regulations

- Philosophy: Union Co-operative was intended to democratize city building by empowering members to make decisions about their neighbourhoods. It is believed that such involvement also reduces risks to investing members as they become more familiar with the business model of the Co-operative.
- Institutional pressures: The real estate market moves quickly (e.g., amending purchase agreements in iterative signbacks). Such decisions require consistent involvement (e.g., missing a meeting makes it difficult to make an informed decision in a subsequent meeting) and a degree of technical expertise (e.g., commercial mortgage requirements). Regulatory restrictions prevent the Co-operative from sharing information about a draft offering statement before it is approved by the securities regulator. These pressures limit member engagement.
- Governance strategy: Staff develop policies that inform and constrain the board and executive of Union. Members are asked to review draft policies and suggest changes prior to ratification. For example, a policy permits the board to approve a purchase agreement, but then requires property data be shared with members, including pro forma and due diligence reports. The board must ask members if they support the decision to acquire a given property, but the board makes the final decision. Member focus groups and interviews inform the Co-operative's strategy and future offerings, but draft offering statements remain confidential.

Growth Orientation vs. Tax Act Restrictions

- Philosophy: The Co-operative was founded in response to rising rental rates that are becoming unaffordable for a growing share of residents and local businesses. Growth is required to permanently preserve more units.
- Institutional pressures: Co-operative dividends are more tax efficient than dividends provided by private corporations or interest payments from non-profit community bonds> Passive income (including income earned from renting affordable housing) earned by co-operatives are taxed at a lower rate than for private corporations, and co-operative shares can qualify to be held in self-directed RRSPs. The Tax Act states that for co-operatives to receive these benefits, no person may own more than 10% of any class of shares, and 90% of the owners of a co-operative shares must be individuals. These restrictions limit the ability of wealthy investors, including charitable foundations, to capitalize co-operatives.
- Governance strategy: A short-term strategy has been to prohibit corporations, family trusts, and foundations from investing in the shares of Union Co-operative, and to cap individual investments. The Co-operative intends to file an election to become a public corporation under the Tax Act. As a result, the 10% and 90% restrictions described above will cease to apply, but the Co-operative will continue to enjoy the ability to declare eligible dividends and for its shares to be held in RRSP accounts. The election will not change the legal status of Union as a co-operative corporation, however, professional fees will be incurred.

Permanent Affordability vs. Stranded Equity

- Philosophy: Permanent property ownership requires that members act as trustees, and the redemption of a share does not result in the division of the common asset.
- Institutional pressures: While charities are subject to legislated asset locks, for-profit social enterprises, co-operatives, and not-for-profits generally are not. The Co-operative's articles and by-laws require that any residual assets be donated to a registered charity. However, any policy can be broken with sufficient economic incentive.
- Governance strategy: Several strategies have been identified, including: create a new membership class for charitable foundations that can veto fundamental changes; and issue stock dividends equal to to an arm's length not-for-profit so that any residual value must be paid to the not-for-profit. Each of these strategies has its weaknesses (e.g., governance complexity of multiple classes), but the lack of regulatory protections will require the Co-operative to reinforce the existing asset lock.

Thanks to the support of the 2021 Bertram Scholarship, I have had the opportunity to advance isomorphism literature beyond the study of established fields to consider the system pressures that influence the governance frameworks adopted within an emerging co-operative. Using an action research approach, I have identified opportunities for policy makers to modernize legal and tax frameworks that constrain social purpose organization governance innovation, and provide social purpose organization practitioners with a Canadian-specific DPO model to analyze and replicate.