



Start Up Lancashire

Social Enterprise

Toolkit

Workbook 2

Legal Structures for Social Enterprises



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Disclaimer

Any information pertaining to the law, legislation and regulation is provided in good faith. You are advised to seek professional advice or consult with the relevant body to discuss the legal position as it relates to you and your enterprise before deciding upon your final course of action. Such bodies will include: Companies House, Charity Commission and HMRC.

The information supplied was checked in December 2012 and may be subject to change, especially legislative and monetary values, so you are advised to check for updates.

E&OE

Introduction

This Workbook has been written to run in conjunction with business adviser support and developed for the 2013/14 Start-up Lancashire programme part funded through European Regional Development Fund (ERDF).

The workbook has been developed to support SUL “Social Enterprise Toolkit” and this workbook includes details on the preferred Legal structures for a Social Enterprise.

In choosing the best structure for your enterprise we always recommend that you seek professional advice.

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Summary

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Would an unincorporated model, which does not have legal requirements, be suitable or should your business incorporate?

There are no hard and fast rules as to when an organisation should incorporate. However, as an organisation you need to ensure the management committee and individuals are protected from unforeseeable risk.

As an unincorporated organisation the liability of members is infinite and if something goes wrong then the individual members may be required to personally pay the debts of the unincorporated organisation.

Company status affords the individuals involved in the management structure of the business 'Limited liability'. Although limited liability protection does have its conditions (see below), there are key instances as the business develops when adopting a company legal structure becomes necessary.

It is recommended that unincorporated organisations consider this when the following situations arise for the business:

- When members are exposed to a high level and/or high risk of debt.
- If the organisation starts to employ members of staff.
- If the organisation takes ownership of a substantial piece of property or lease term.
- If the organisation needs a more substantial legal status, for example to demonstrate independence of a parent organisation.
- If it is a condition of funding.

Limited Liability

Limited liability is a concept whereby a person's financial liability is limited to a fixed sum, most commonly the value of a person's investment in business with limited liability. In many Social Enterprises this is fixed at £1

Setting up a Limited company has a fixed cost. Once you create one you have got to meet obligations to UK taxing authorities, Companies House and you are bound to adhere to certain rules.

A limited company is a "fictional person" that would pay for its own mistakes. However, it is possible to lose the protection offered by a limited company by failing to meet your obligations as a director.

Note: Always seek professional advice and ensure that you fully understand your responsibilities before agreeing to act as a company director.

Community Groups, Voluntary Organisations

This is the simplest format, being a group of people with a shared purpose.

This category covers a whole list of organisations, ranging from small neighborhood groups run by local people to large voluntary agencies with staff. They may be working to improve their local area, campaigning for change or providing a service.

The business itself is not legally separate from its owners. The group will usually have formal governance or set of rules (constitution) to which all members of the management committee sign and agree, but there is no legal obligation to do so.

Unincorporated Association

An Unincorporated Association is a membership organisation. It can be whatever its members want it to be, and carry out whatever activity you choose.

Charitable Enterprise

If your organisation has charitable aims and an income under £5,000 per year you are not liable to register with the Charity Commission.

Features of unincorporated organisations:

- A collection of individuals who have a shared interest or objective.
- The organisation has no separate legal existence.
- Needs a set of basic rules to define how it operates.

Advantages

- Quick and easy to set up.
- Do not have to answer to external authority.
- This format benefits from light regulations (general laws such as VAT and taxes still apply) and can operate relatively informally.
- Can seek charitable status.
- Easily wound-up.

Disadvantages

- Cannot enter into contracts/leases.
- Management Committee can be personally liable for obligations and debt.
- Difficulty in borrowing money or seeking funding.

Trusts

A trust is a legal device which governs how assets given by an individual or organisation are to be used. Many organisations, such as those involved in education, healthcare, providing advice and conservation, can be structured as trusts.

How Trusts work

Trusts are unincorporated bodies, so have no legal identity of their own and do not distribute their profits. They are managed by trustees who do not benefit from the trust, but act on behalf of the community for whose benefit the trust is set up. Trusts have a trust deed which protects their social objectives. This covers the terms under which an individual or organisation is given assets. It also lists the intended beneficiaries and the conditions under which the trust's assets may be used.

Charitable Trust

This format is usually taken when there is a bequest or similar fund that has been restricted to a particular beneficiary group. The governing document is a trust deed or a will. The trust should (in most cases) apply to the Charity Commission to be registered as a charity. It is unlikely that this model will be a social enterprise.

Development Trusts

Development Trusts are community owned and led organisations, and do not distribute any profits. They provide a hub of trade or service with the aim of regenerating their local community e.g. to develop or manage property, restore buildings or improve the environment.

There is no standard legal form for a Development Trust. Where they take on a building and/or staff most will incorporate to reduce the risks detailed below. They can be a company limited by guarantee, an Industrial and Provident Society and many register as charities.

Advantages

- Quick and easy to set up.
- If unincorporated does not have to answer to external authority.
- A trust is likely to be less intimidating than a company limited by guarantee or IPS for those considering whether to participate in decision making.
- This format benefits from light regulations (general laws such as VAT and taxes still apply) and can operate relatively informally.
- Easily wound-up

Disadvantages

- Management Committee can be personally liable for obligations and debt. It is the owners themselves who enter into contracts and agreements and so take the financial risks personally.
- It may also make securing funding difficult.
- Cannot enter into contracts/leases

Industrial and Provident Societies (IPS)

An IPS is an incorporated organisation and its members benefit from limited liability. An IPS must register with the Mutual Societies Registration section of the Financial Services Authority, the regulatory body. In general, regulation is lighter than for Limited Companies and the accounting requirements far less stiff.

This legal form of incorporation covers two distinct types of society:

- **Community Benefit Society** which must demonstrate that it operates for the benefit of the community rather than solely for its own members. Profits are not distributed amongst members, or external shareholders, but returned to the community.
- **Co-operative Society** which must be owned and controlled by a group of people with a shared aim.

They have rules of governance setting out the powers of the members and directors. However they are usually based on democratic principles one member, one vote.

Features:

- Societies are regulated by the Financial Services Authority and have to send annual returns.
- Must be a “true co-operative” membership organisation.
- Cannot seek charitable status.
- Model Rules / Constitution.

Advantages

- Can acquire property and enter into contracts/leases.
- Take and defend legal proceedings.
- Committee members protected from personal liability.
- An IPS has the ability to raise capital from the membership via an issue of shares.
- It is slightly more common within an IPS to include provisions allowing for the distribution of surplus profits to members i.e. via a dividend on shares.
- The body of statutory requirements applicable to an IPS is less detailed than in relation to a company limited by guarantee.

Disadvantages

- Comparatively expensive and onerous to register.
- It is more difficult (and significantly more expensive) to tailor the rules of an IPS to the needs of the particular organisation, as compared with tailoring a set of memorandum and articles.
- Loss of Privacy.
- Controls and Bureaucracy.
- Cannot register as a charity – therefore restricts funding opportunities.
- The structure of an IPS tends to be unfamiliar to banks and other bodies dealing with the organisation.

Co-operatives

These are businesses that are fully or majority-owned by their members, who may be employees, consumers, others in the community or a mix of these.

Worker co-operatives do not have shares as in a Company Limited by Shares. The money required to set the business up is raised by way of a loan either from banks, private benefactors or members themselves. Such loans do not give the lender any say in how the business is run nor a right to any profits. Worker co-operatives registered as a Company Limited by Guarantee also benefit from Limited Liability in the event of closure. Worker co-operatives share many of the characteristics of other small businesses but exhibit some special features:

Advantages

- Registered companies or registered as an [IPS] Industrial and Provident Society.
- All employees are members rather than partners.
- Democratic control – one member, one vote, irrespective of length of service.
- Profits belong to the members only.
- Pursuit of social as well as commercial aims.
- Grants may be available from regional and national sources.
- Co-operatives are more sustainable than other forms of small business - survival rates are higher and they create more jobs, which are less likely to leave the local area when the business is successful.
- Co-operatives contribute to local community regeneration and supply chain development.
- Co-operatives encourage all-round personal development, including entrepreneurial and business skills in all their members.

Disadvantages

- Limited return on capital invested.
- Decisions may be delayed or deferred due to lack of agreement between members.
- Difficulties in ensuring all members 'pull their weight'.

Note: There is also a Cooperative CIC model which bears the features of a cooperative in an incorporated CIC framework governed by M&As.

Company Limited by Guarantee (CLG)

In previous years this has been the most common legal structure for a social enterprise.

Under Company Law a limited company enables any limited company to be set up by an individual. However, there can be issues about one or two people setting up as a social enterprise.

The Memorandum & Articles of Association (M&A) must state that any surplus is put towards the company's social purpose and usually defines the company as democratic and accountable to the community through its membership. As a social enterprise this will be detailed in the rules, their rules will also include a clear socially focused dissolution clause.

Every incorporated community enterprise must have both members and directors. How people qualify for these roles varies. It is the members that set the company up. In some cases all members will be directors, in others all directors will be members but not all members will necessarily be directors. Sometimes (e.g. with co-optees) directors need not be members. Directors are elected or appointed by the membership of the business. Members do not have to be directors and they can choose to select directors to run the company on their behalf. If the company is not a membership organisation then it is usual that the members are also the directors.

The directors can be referred to by several names, such as General Council, Management Committee or Board of Directors. It doesn't matter what the directors are called; they are still directors in law. Directors have the power to carry out the business of the company. The directors are agents of the company and are not personally liable for its debts.

There are certain duties specific to Directors. The number of directors of all types of Companies disqualified or classified as unfit is rising and in 1990 totaled more than 1,200 and nearly a third of all companies failed to file their returns on time. It goes without saying therefore that it is very important to be aware of the various rules that can result in action being brought against you.

A CLG cannot raise finance by issuing shares, nor pay dividends to its members/directors.

Features

- Company Limited by Guarantee (Companies Act 2006).
- No shareholders but "guarantors" (£1).
- Profits are put back into the company.
- Can register as a Charity.
- Articles of Association needed.

Advantages

- Separate legal entity.
- Democratic – through members (if there are any) with voting rights.
- Managed by Board of directors.

- Limited Liability of Directors (and members).
- Can acquire property and enter into contracts/leases.
- Take and defend legal proceedings.
- Clarity of purpose – liked by funding bodies.
- Accountability and transparency.
- Suitable for “not-for-profit” organisation.

Disadvantages

- Controls and bureaucracy.
- Loss of privacy (directors info are public domain).
- Annual accounts to be filed with Companies House and are publically available.
- Can’t get charitable trust money.
- Limited companies with less than three unrelated directors are not eligible for funding from some grant funders including BIG Lottery.

Company Limited by Shares (CLS)

A company limited by guarantee can also be limited by shares. It is likely to be compared with a partnership/sole trader structure in the context of a trading operation.

It is a rare form for a social enterprise and there would need to be compelling reasons to choose this model. One example is as an income generation arm of a charity, which holds all the shares, so that the profit benefits the charity.

Limited Liability Partnership

Not a common form for a social enterprise. A Limited Liability Partnership shares many of the features of a normal partnership - but it also offers reduced personal responsibility for business debts.

Unlike members of ordinary partnerships, the LLP itself is responsible for any debts that it runs up, not the individual partners. We would look for social objects and an asset lock or dissolution clause in the M&As.

Community Interest Company (CIC)

The Community Interest Company is a newer legal form for social enterprise with special features to ensure profits and assets are used for the good of a community.

A CIC can be: a company limited by shares; or a company limited by guarantee.

The information on members and directors in a CLG apply to a CIC.

CICs commit their assets and profits permanently to the community by means of an “asset lock”. Its members (or directors) can take dividends but there is a limit on how much they can be distributed and dividends are ‘capped’.

The Dividend Cap

In the case of a CIC existing as a company limited by shares, a ‘dividend cap’ must be put in place. The purpose of this is to ensure that a balance is achieved between providing an attractive investment opportunity (often essential in stimulating and maintaining the financial backing required to run the CIC) and making sure that the majority of the profits made are applied for the community benefit.

The cap has three elements:

- A limit on the amount of dividend that can be paid on any share
- An aggregate limit on the total dividend declared
- An ability to carry forward unused dividend capacity

They report to an independent regulator, the Regulator of Community Interest Companies. A big advantage is that CIC’s not-for-profit status is visible as well as assured.

CICs have to register with Companies House and then apply to the new Regulator for CIC status. The CIC Regulator’s website has detailed guidance notes on all aspects of setting up a CIC, or converting an existing limited company to a CIC. www.bis.gov.uk/cicregulator

It is worth noting that a CIC cannot register as a Charity, but that a Charity may set up its trading subsidiary as a CIC.

CICs differ from a charitable company in that it can be established for any legal purpose which benefits the community, whereas a charity must have exclusively charitable purposes. A further advantage is that a CIC is subject to lighter regulation than a charitable company. On the downside, a CIC may not be eligible for funding which is available to a charity.

Advantages

- Recognised social enterprise structure.
- not-for-profit status is visible as well as assured
- Advantages are the same as those of an incorporated company by guarantee.

Disadvantages

- Disadvantages are the same as those of an incorporated company by guarantee.

Charitable Organisations (Charities)

A Charitable Company has to meet the strict criteria for social purpose; this is defined within Charity Law:

- To relieve poverty.
- To advance education.
- To advance religion.
- For other purposes beneficial to the community.

Any aims outside these areas may not be eligible for charity status but will be deemed as businesses with social purposes.

A charitable company has to be registered with the Charity Commission if it has a turnover of more than £5000 p.a.

Becoming a charity can have advantages for a social enterprise but Charity Law has limits on what trading activities the Charity can pursue.

Charities get several tax benefits, which can financially be very beneficial. If the funding model is heavily reliant on donations and fundraising, then a charity structure may be the best option because gift aid may be applied offering 26p in every £ raised thus increasing the income.

A charity doesn't need to be a Limited Company but it is recommended if the trustees are subject to the risks detailed earlier. A charity is a membership organisation (a list of members is part of the Company Register) and accountable to the community. It also has a legal identity separate from its members and its directors are agents of the company and are not personally liable for its debts. The directors are called trustees.

Establishing an incorporated Charitable Company currently involves registering with both Companies House and the Charity Commission.

As a charity all surplus and profit must be used in pursuit of its charitable aims. No surplus or profit can be paid to members.

Charity Law is quite clear about the role of the board of trustees in governance. Trustees aren't paid so don't usually work within the charity as employees. This is one of the major problems for the social entrepreneur who seeks to work within the charity and retain a controlling interest on the Board.

- Charity Trustees must neither benefit nor profit from their trust.
- Charity Trustees cannot be employed by the Charity.
- Charity Trustees cannot be paid for services to the charity except they provide services in a professional capacity e.g. Solicitors or Accountants.
- The family or the business of a Charity Trustee may not benefit.
- Charity Trustees must declare a conflict of interest if there is any possibility of a benefit arising from a service or transaction.

- Charity Trustees can however be reimbursed for travel and other expenses at a level decided and documented in minutes by the Board.
- Charity Trustees must declare and minute duality of interest if torn between two different roles.
- Charity Trustees appointed by an external body or with a pecuniary interest or dual role must be aware that decisions must be made without regard for their interest of the views of their appointing body.

Advantages

- Trustees have power to raise and borrow money.
- The word alone invariably engenders goodwill and positive feedback.
- By virtue of being a charity, certain organisations are able to automatically overcome the first hurdle in the quest for funding.
- Large number of grant funding Trusts only fund registered charities.
- It is easy to attract volunteers.
- Tax Relief is available: Income (Gift Aid), Corporation Tax, Stamp Duty, rates, Inheritance Tax, Capital Gains Tax & VAT.

Disadvantages

- Trading not allowed other than for primary purpose.
- Limited by law with regard to both political affiliation and campaigning.
- Increased legal bureaucracy.
- Need for compliance with both the Companies' Act and Charity Law.
- Highly regulated by the Charities Commission and have to file annual reports and returns in addition to having their finances examined or audited.
- Requires the company to have access to financial expertise and charity knowledge.

Charitable Incorporated Organisation (CIO)

The Charitable Incorporated Organisation is a new legal form.

The CIO has been created in response to requests from charities for a new structure which could provide some of the benefits of being a company, but without some of the burdens.

The two sets of regulations setting out the legal framework for CIOs, were passed in December 2012 and registration started on 2nd January 2013.

A CIO:

- An incorporated form of charity which is not a company.
- Only has to register with the Charity Commission and not Companies House.
- Is only created once it is registered by the Charity Commission.
- The governing document will be a constitution.
- Can enter into contracts in its own right and its trustees will normally have limited or no liability for the debts of the CIO.

All details about this new structure are available at www.charity-commission.gov.uk

Social Firms

Social Firms are businesses set up specifically to provide integrated employment or training to people with a disability or other disadvantage in the labour market, and they are usually limited companies or co-operatives.

They choose their legal structure from those detailed above.

Mutuals

These are becoming increasingly popular as Government encourages public sector staff to set up their own social enterprises, particularly former NHS services.

They are businesses owned by their members, often staff at all levels. The term has more recently been used to cover a range of organisational forms including co-operatives, employee-owned businesses and social enterprises.

They can deliver high levels of staff motivation and there is evidence that organisations where staff have a role in governance, significantly outperforms the average.

Voluntary and Community Sector (VCS)

organisations developing as social enterprises

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Culture change

Often one of the biggest challenges for voluntary or community organisations in developing a social enterprise is achieving the culture change that is required within the organisations. Your aim will be to run a business. This will require your organisation to have a more commercial culture.

To achieve success, you will need a management board or committee, as well as your chief executive and senior management team, to be fully on board.

Given the resource implications associated with starting any business it can be tempting to bring in consultants. In some respects, this might be advisable, particularly if they are bringing specialist expertise to the table. However, you should be wary of becoming overly depended on consultants. The culture change that will be required is an internal one.

Consequently, it would be advisable to involve as many staff as possible in the process and ensure that it leaves a lasting legacy in terms of assimilated knowledge and understanding about any strategy developed.

Attitude to risk

For many VCS organisations aspiring to develop a social enterprise, the risk of failure will be one of the main barriers to development. Your organisation might have a very low risk threshold and, because failure is not an option, then anything that might fail is unlikely to be considered. If your organisation has a history of grant funding then the transition to running a business will certainly entail a much higher degree of risk. There are many factors that can cause business failure within the private sector and, these are equally as valid in the social enterprise sector.

Some of the common reasons for failure are:

Poor cash flow – might lead to loss of suppliers or inability to pay bills.

Significant changes in the market – could lead to customers buying from someone else.

Loss of key staff – with no succession planning in place your organisation might lack the key skills necessary to drive the business.

Poor financial management – will lead to problems such as unrealistic sales targets or higher cost of sales.

In the course of developing your social enterprise, you will obviously aim to reduce these risks but they cannot be avoided altogether. For this reason, you should constantly review and reassess your business plan and how your business is developing.

We have found that it is advisable, in risk management terms, to invest a proportion of any surpluses into further business development or in accruing reserves. This will act as a cushion should you experience any unexpected drops in commercial income.

Summary

Things to consider before choosing a legal structure:

Risk

- Contracts / property
- Liability position of members

Democracy

- Accountability and responsibility
- Unincorporated or Incorporated

Type of organisation and appropriate governing document:

ORGANISATION TYPE	GOVERNING DOCUMENT
Unincorporated Association, Society, Club	Constitution
Industrial Provident Society, Coops and Mutuals	Rules
Development Trust, Social Firm	Trust Deed
Incorporated Company, limited by guarantee/shares	Memorandum and Articles of Association
Community Interest Company	Memorandum and Articles of Association and Community benefit statement
Charitable body	Memorandum and Articles of Association and stated Community objects
Charitable Incorporated Organisation	Constitution

Limited by guarantee (CLG)

To register a company with Companies House you will need to complete the IN01, Articles of Association, and Memorandum. In registering a CIC a CIC36 is also used.

All these forms are available from www.companieshouse.gov.uk and www.cicregulator.gov.uk.

IN01

This details:

- The name of the Company.
- Where the registered office of the Company is situated.
- Who the directors are and their contact information.
- Which model of Articles is being used? (for a social enterprise you may need to provide bespoke ones to detail your social purpose)

Articles of Association

This document sets out:

- What the Company will do, its social purpose.
- The rules for the operation of the Company's internal affairs.
- The rights and duties of its members.
- The asset lock and dissolution clause.

Memorandum

- Details of the members setting up the company.

Community Interest Company (CIC)

A CLG can be made into a CIC. This usually happens at setting up stage but can be done later for an established company.

The CIC36 form defines your Community Interest Statement and how the activities will benefit the community. The form can be submitted at the same time as registering with Companies House and the CIC Regulator will approve the application making it eligible to be called a CIC.

Note: you can either use CIC or Community Interest Company instead of Limited but you must choose which appendage you want from the outset. You cannot alternate or use them both.

The company will have a unique ID number from Companies House and be listed on their company register.

How to register a charitable company

The process is a bit different if you want to become a charitable company. To do this you need to register the company with Companies House first. You'll need a new governing document called memorandum and articles.

The Charity Commission has a model constitution (GD1) for charitable companies which you can download from their website at:

http://www.charity-commission.gov.uk/Start_up_a_charity/Guidance_on_registering/mgds.aspx

By following the rules of the Companies Act there is little more required in the way of record keeping. You must make an annual return and send a signed copy of your annual accounts.

Cheques must indicate that the organisation is a registered charity.

Add the registered number to all your stationery.

Abide by the rules laid down by the local authority for fundraising events that involve licensing and registering under the small lottery rules. Make sure your Registered Charity number appears on all tickets, programmes and posters. Make the requisite returns to the local authority after events.

The Charity Commission provides excellent booklets on all aspects of running a charity, clearly written without jargon.

Issue all your trustees with an induction pack covering the company and charitable registration, which will include a guide for trustees.

The **Charitable Incorporated Association** (CIO) available from January 2013 - there is the advantage that you only need to be registered with and regulated by the Charity Commission.

Requirements for reporting and for annual accounts should be simpler and cheaper. Further information is available on the Charity Commission website at: <http://bit.ly/fMyrmw>