

What is a legal structure why is it important?

A legal structure is created by separating an organisation from the individuals who operate it. If you are a sole trader or self employed, there is no separation between the enterprise activities and you as the person; adopting a legal structure for your organisation creates that separation.

There are a variety of legal structures open to organisations in the UK; this guide provides an introduction to why you need a legal structure and what you should consider when choosing an appropriate legal structure for your organisation.

Why do you need a legal structure?

There are a number of reasons why you might consider a legal structure. Firstly it is about protecting yourself from personal liability. You may also want a legal structure to create a way of employing other people to work with you. A legal structure may also lend you credibility with potential customers, funders, and suppliers. Often you will also find that a legal structure is a requirement for the type of work you want to undertake.

Legal structures and social enterprise

Deciding on a legal structure for your social enterprise is a complex decision, simply because there are so many different types of business model to choose from. This is further complicated by the range of funding options available and the ways in which you relate your social aims to your commercial aims.

This guide is the first in a series of three guides that offer a short introduction to some of the more common legal forms and their advantages and disadvantages. Together with the guides 'summary of legal structures' and 'frequently asked questions on legal structures,' the topics covered include:

- key issues you need to consider before deciding which structure to adopt
- a description of common legal structures used by social enterprises
- a Frequently Asked Questions section
- a handy 'at a glance' table, providing an overview of the key criteria of each legal structure
- links to various organisations which can provide you with further advice – it's a good idea to contact these if you still have queries after reading this guide

Ultimately, it is often advisable for you to seek advice from an expert if you are still not sure which legal structure to adopt.

Initial considerations

There are several issues to consider when deciding on a legal structure for your social enterprise. These include:

- limiting your personal liability
- who owns the organisation
- how you will fund the organisation, both in the short term and long term
- how it is governed, and whether that process is transparent
- what happens to the profit once it is made

Limited liability

When starting any type of enterprise there is the potential that the owners and/or management will be held responsible for financial loss of the enterprise, or financial loss caused by the enterprise.

Sole traders and partnerships do not have any form of legal cover that protects them from personal liability. This is also true for Voluntary Associations (see our guide on summary of legal structures for further information). Most other legal forms give the owners and managers protection from personal liability. Owners have limited liability and managers are protected from financial liability unless they have acted negligently or fraudulently.

It is therefore a good idea to choose a limited liability structure for your enterprise. This could be in the form of a limited liability company or a co-operative structure.

Charities can also have a limited liability structure. Some charities behave like social enterprises. However, because of legal restrictions on trading charities this is not a popular choice for social enterprises. Charities seeking sustainable and diversified income tend to set up captive trading companies that operate as social enterprises.

Ownership

Ownership of a social enterprise depends on the legal structure you choose. If the structure is a company limited by shares (profit making company) you can have shared or outright ownership. The more shares you own the more votes and influence you have over the strategy, management and operations of the enterprise.

A company limited by guarantee (non-profit company) is different given that the founder of the company does not own the company or any shares. It is governed by a voluntary board of people who are there to act in the best interest of the social enterprise and the community it serves. Instead of being an owner of shares, the founder will be a member of the board of directors and your liability will be limited to £1 or more depending on what you decide. This is then stipulated in the company set of rules. The group of people that sit on the board are jointly responsible for making the strategic decisions on behalf of the company, and it is this democratic characteristic that funders and public bodies appreciate. It gives them the confidence that the board will be making the right decisions based on what's best for the organisation and its social work, as opposed to what is best for the directors.

In the co-operative model, you can have ownership of the organisation and you are allowed to invest up to £20,000. However, this ownership is shared with other members and you are restricted to one vote.

Therefore if control and ownership are important to you, a company with shares may be more appropriate for you than a non-profit company or a co-operative. However, this structure precludes you from receiving grants (see below).

Most social entrepreneurs are happy with sharing decision-making control with other members on the board, and this need not necessarily be an issue for you, but it is something you need to be aware of.

The additional pros and cons of these legal structures are explained in the guide 'summary of legal structures.'

Funding

You may have heard that social enterprises have the ability to access a wide range of funding and finance including grants, investment, loans, contracts, etc. However, in reality it will depend on your legal structure.

Companies with shares are not usually allowed to receive grants. Most grant making funders will only fund companies that have non-profit distribution enshrined in their constitution. On the other hand, guarantee companies (non-profit companies) do not have shares to sell and so cannot attract investment in the way that companies with shares can (an investment is a receipt of cash in exchange for partial ownership of an enterprise that allows an enterprise to start trading, launch new products or increase activities).

This means that deciding to go for a structure that allows grant funding will prevent you from being able to access investment finance in the long term. This is a challenge shared by many social enterprises given that at the moment there is no one legal structure that allows you to do both. Therefore, you should first establish what the most likely form of income you will rely on in the long-run is and choose a legal structure that enables you to access it.

There are also a number of different types of co-operatives and most cannot access grant funding. There is a type of co-op however which is charitable in nature, known as a co-op established for the Benefit of the Community, (a different legal form of co-operative). Because of its charitable aims this type of co-op can access grants. However, it cannot be funded through investment.

All forms of social enterprise can access loans.

Governance

Governance describes the way an organisation is managed and how it conducts itself. This is demonstrated by the policies and procedures within the organisation and the quality of its management.

It helps to understand some of the terminology associated with management:

- **Members** – these are the owners of a company. The members of the company appoint management, the directors, to operate the company on their behalf.
- **Directors** – these are the people who manage the company. There are two types of directors involved in management:
 - **Executive directors** – they undertake daily operational as well as strategic responsibilities for a company. They are usually paid for this and are on the company's payroll.
 - **Non-executive directors** – these directors are not involved in the daily operations of the company. Instead they are appointed for the advice they can give because of their experience and expertise. They may occasionally be called upon to help with particular activities or negotiations. They are not on the company's payroll but may be paid on a sub-contract basis. In law there is no difference between the two types of directors.

Limited companies are only legally required to have one member or director. However, as most social enterprises claim to be operating for the good of stakeholders, the community or society, in general it is good practice to have at least three directors and five or more members. This demonstrates that there is a wider involvement by the community in your enterprise. This also allows the enterprise to have a wider set of complementary skills on the board as well as demonstrate wider stakeholder involvement and understand the needs of the community that the organisation aims to support.

Grant funders are also more likely to fund an organisation with wider membership. By and large, a greater number of directors and members improves the level of oversight held by the management, and ensures that there is transparency in what the enterprise is doing. Also, it ensures that the way grant money is being spent is overseen by more than one person.

Many larger charities are also limited by guarantee companies. In this instance, charity directors are known as trustees. They are responsible for the strategy and they oversee the management team. They are often referred to as working in a "non-executive" capacity. The management team undertakes the day to day functioning of a charity, they are the executive team.

Directors of limited companies can be employed in a full time or executive capacity and can be paid for this as an employee of the company. For smaller social enterprises this position is usually taken by the founder. Other directors will contribute their time and advice on a voluntary basis. If the company can afford it then the non-executive directors can also be paid. Trustees of charities are not allowed to be paid except by special permission from the Charity Commission. Please note that the management team and the chief executive of a charity, who by definition are not trustees, can be paid.

To reiterate this important distinction; directors of social enterprises can be paid for managing the enterprise. If the social enterprise is a charity then the directors, i.e. the trustees, cannot be paid.

Co-ops are legally obliged to have at least three members on the management committee, their equivalent of a board of directors. They can be paid for their duties.

Profit distribution

There is nothing wrong with social enterprises aiming to make a profit or surpluses. In fact this is what generally differentiates them from traditional charitable organisations and helps them to be more sustainable in the long run.

What you need to decide is what you plan to do with the surpluses or profits your organisation may generate. Generally speaking, social enterprises will reinvest profits back into the business in order to grow the enterprise and increase its social impact. However, some prefer to be able to distribute some of these profits to its directors (owners) or to its investors in the form of dividends.

Your legal structure will dictate what you can do with your profits. If you are hoping to attract investment finance, then you will need to have a legal structure that allows you to distribute your profits to investors. This would include a company limited by shares, or a CIC Ltd by Shares. Further details on these legal structures are included in the guide, 'summary of legal structures for social enterprises.'

If your plan for your organisation is that profits will always be reinvested back into the organisation, then you may want to choose a legal structure that enforces this. This could be in the form of any non-profit structure such as non-profit companies, charities, CICs Ltd by Guarantee, charitable co-operative, amongst others. Grant funders will only fund organisations where the constitution states that there will be no profit distribution to its members. So if you are going to seek grant funding you will be choosing one of these legal structures.

Some social enterprises are owned by charities and they will distribute its profit to the charity to enable it to fulfil its charitable objects. This combination is normally a Charity with a trading arm.

Most co-operatives will distribute profits to their members.

Further information

Further information on the different types of director:

<http://www.businesslink.gov.uk/bdotg/action/detail?site=181&r.s=m&r.l1=1073858787&r.lc=en&r.l3=1074428854&r.l2=1079568262&type=RESOURCES&itemId=1074429133>

Read our guide 'summary of legal structures for social enterprise':

<http://www.blondon.com/socialenterprise/Summary-of-legal-structures.html>

Read our guide on 'frequently asked questions on legal structures':

<http://www.blondon.com/socialenterprise/Frequently-asked-questions.html>

Read our guide on Charity Trading:

<http://www.blondon.com/socialenterprise/Charity-trading.html>